Supreme Court, U.S.
FILED

97 706 OCT 21 1997

No. ____ OFFICE OF THE CLERK

IN THE

Supreme Court of the United States

October Term, 1997

CENTURY OFFSHORE MANAGEMENT CORPORATION,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

Petition for a Writ of Certiorari To The United States Court of Appeals For the Sixth Circuit

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. Whether the Department of the Interior is precluded from claiming royalties on non-recoupable settlement payments made by oil and gas purchasers to federal oil and gas lessees on the ground that such royalty claims exceed the DOI's statutory authority under the Outer Continental Shelf Lands Act, 43 U.S.C. § 1331, *et seq.*, particularly in light of certain DOI regulations and administrative decisions interpreting that statute.

2. Whether the United States Court of Appeals for the Sixth Circuit, in reviewing a bankruptcy court's grant of summary judgment, exceeded its appellate authority by improperly applying a *de novo* standard of review to the bankruptcy court's findings of fact rather than the required clearly erroneous standard of review.

RULE 29.6 STATEMENT

Petitioner has no parent company or nonwholly owned subsidiary to be listed pursuant to United States Supreme Court Rule 29.6.

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CENTURY OFFSHORE MANAGEMENT CORPORATION,
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For the Sixth Circuit

PETITION FOR A WRIT OF CERTIORARI

Century Offshore Management Corporation petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App. 1a-19a) is reported at 111 F.3d 443 (6th Cir. 1997). The opinion of the district court is not reported and is attached hereto (App. 21a-36a). The decision of the bankruptcy court (App. 37a-52a) is reported at 185 B.R. 734 (E.D. Ky. 1995).

JURISDICTION

The judgment of the court of appeals was entered on April 14, 1997, and a timely petition for rehearing and suggestion for rehearing *en banc* was denied on July 23, 1997 (App. 20a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254.

STATUTORY PROVISIONS INVOLVED

1. The relevant provision of the Outer Continental Shelf Lands Act (OCSLA), 43 U.S.C. § 1337(a) (1986), provides in pertinent part:

> (1) The Secretary is authorized to grant to the highest responsible qualified bidder or bidders by competitive bidding, under regulations promulgated in advance, any oil and gas lease on submerged lands of the outer Continental Shelf which are not covered by leases meeting the requirements of subsection (a) of section 1335 of this title. . . .The bidding shall be by sealed bid and, at the discretion of the Secretary, on the basis of--
>
> (A) cash bonus bid with a royalty at not less than 12 1/2 per centum fixed by the Secretary in amount or value of the production saved, removed, or sold;
>
> [Paragraphs (B) through (H) similarly describe possible alternative bidding mechanisms.]

2. 30 C.F.R. § 206.152(h) (1997), commonly known as the "gross proceeds" rule, provides in pertinent part:

> Notwithstanding any other provision of this section, under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances determined pursuant to this subpart.

3. 30 C.F.R. § 206.151 (1997) provides in pertinent part:

> Gross proceeds (for royalty payment purposes) means the total monies and other consideration accruing to an oil and gas lessee for the disposition of [gas] ***.

STATEMENT

1. Petitioner's Offshore Oil and Gas Leases Under OCSLA and Royalty Obligations to DOI

Petitioner Century leases submerged lands on the outer Continental Shelf from the Minerals Management Service ("MMS"), a subagency of the Department of the Interior ("DOI"), in order to explore for and extract natural gas and crude oil.[1] The DOI leases are issued pursuant to Section 8 of the Outer Continental Shelf Land Act of 1953 ("OCSLA"), 43 U.S.C. § 1331 *et seq.*, and they incorporate the royalty provisions of Section 8(a) of OCSLA, 43 U.S.C. § 1337(a).[2] Century's royalty obligations are governed by OCSLA, the leases, and DOI regulations. Specifically, Century is obligated to pay royalties to DOI on the "amount or value of production saved, removed or sold" from the leased premises.[3]

2. Petitioner's Natural Gas Sales Contracts with Enron Gas Marketing, Inc.

Century, like other producers of natural gas, sells the natural gas produced from outer Continental Shelf leases to pipeline purchasers under natural gas sales contracts. In 1989 and 1990, Century entered into two fixed-price natural gas sales contracts (collectively, the "Fixed-Price Contracts") with Enron Gas Marketing, Inc. ("Enron").[4] The first natural

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[1] App. 38a.

[2] App. 2a-3a.

[3] *See* 43 U.S.C. § 1337 (1986) (requiring payment of royalty on the "amount or value of the production saved, removed, or sold"); 30 C.F.R. § 206.152(h) (1997) (providing that "[u]nder no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from disposition of the produced substances"); *see also* App. 40a (noting that the Century/DOI leases, which incorporate applicable federal statutes and regulations, provide for the payment of royalty on a percentage of the value of "production saved, removed or sold").

[4] App. 3a-4a.

gas sales contract ("ST 107 Base Contract"), executed on December 20, 1989, covered one of Century's leases with DOI, commonly known as South Timbalier Block 107 Lease ("ST 107 Lease").[5] The second natural gas contract ("WC 368 Base Contract") covered two of Century's leases with DOI, commonly known as the West Cameron Block 368 Lease ("WC 368 Lease"), and the Bretton Sound Block 53 Lease ("BS 53 Lease").[6]

Pursuant to the Fixed-Price Contracts, Enron agreed to either: (1) purchase certain minimum monthly quantities of the natural gas that Century produced from the leases; or (2) make non-recoupable payments to Century in each month in which Enron failed to take-and-pay for those minimum quantities of gas.[7] Under these agreements, then, Enron could avoid its obligation to purchase minimum quantities of gas from Century in one and only one way: by making a non-recoupable payment to Century.

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[5] *Id.*

[6] *Id.*

[7] *Id.* Natural gas sales contracts, take-or-pay payments, and "make-up" gas are discussed generally in the Fifth Circuit's decision in *Diamond Shamrock Exploration Co. v. Hodel*, 853 F.2d 1159 (1988). As that decision points out, some take-or-pay payments may eventually be refunded (*i.e.*, recouped) during a subsequent contract period by purchasing quantities of natural gas during that period in excess of the minimum purchase requirements for that period, *i.e.*, by purchasing so-called "make-up" gas. *Id.* at 1164. In other cases, the take-or-pay payment is non-recoupable, *i.e.*, the payment can never be recouped by purchasing gas in excess of the minimum purchase requirements during a subsequent contract period. *Id.* There is no dispute that the original contracts between Century and Enron provided that Enron would make *non-recoupable* payments to Century if Enron failed to take and pay for the contractual minimum quantity of gas. *See* App. 4a ("once made, Enron's payments under the take-or-pay clause were gone for good").

3. Enron's "Buy-Out" of Its Contractual Obligations Under The Fixed-Price Contracts

Sometime during 1991, Enron approached Century with a request that the parties negotiate a "buy-out" or purchase of the Fixed-Price Contracts by Enron.[8] During the negotiations that followed, Enron presented Century with a computation showing the present value of the monthly non-recoupable payments that Enron would be required to make to Century over the remaining terms of the Fixed-Price Contracts if Enron failed to purchase the required minimum monthly quantities of gas.[9] Century presented Enron with a similar calculation.[10]

On the basis of additional negotiations concerning those calculations, the parties agreed to terminate the Fixed-Price Contracts.[11] Under the termination agreement, Enron bought out its obligations under the Fixed-Price Contracts by making a lump sum payment to Century of $12,250,000.[12] As a result, Enron's future obligations under the Fixed-Price Contracts, including Enron's obligation to make monthly non-recoupable payments to Century when minimum quantities of gas were not purchased, were terminated as of January 1, 1992.[13]

Century and Enron executed new and separate natural gas purchase contracts effective January 1, 1992 (the "Spot-Price Contracts").[14] Pursuant to these new contracts, Enron had the

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[8] App. 5a.

[9] App. 39a.

[10] *Id.*

[11] App. 40a.

[12] App. 5a.

[13] *Id.*

[14] *Id.*

right, under specified conditions, to purchase certain quantities of natural gas from the ST 107, WC 368, and BS 53 Leases at "spot" prices.[15] However, under the Spot-Price Contracts -- and unlike the Fixed-Price Contracts -- Enron was *not* obligated purchase any gas whatsoever, nor was it obligated to make non-recoupable take-or-pay payments to Century if it elected not to purchase gas.[16]

4. The Proceedings Below

a. United States Bankruptcy Court Proceedings

On August 23, 1993, Century filed a voluntary petition for relief under Chapter 11 in the United States Bankruptcy Court for the Eastern District of Kentucky.[17] During the bankruptcy proceeding, the United States of America, on behalf of the MMS, filed a proof of claim for $1,855,004 in royalties on the $12.25 million non-recoupable settlement payment that Enron made to Century in order to terminate the Fixed-Price Contracts. The government alleged that royalties were due on the non-recoupable settlement payment because, according to the government, Enron made the payment not to extinguish its obligations under the Fixed-Price Contracts, but rather to receive a reduced price for gas that Enron intended to purchase under the new Spot-Price Contracts.[18]

Century contested the government's claim, and on December 16, 1994, Century filed a verified motion for sum-

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[15] *Id.* A "spot" price is by definition a market price that fluctuates over time.

[16] *Id.*

[17] The bankruptcy court had subject matter jurisdiction under 28 U.S.C. § 1334; 28 U.S.C. § 157; and Local Rule 21 of the United States District Court for the Eastern District of Kentucky.

[18] In effect, the government argued that Enron's non-recoupable $12.25 million settlement payment was "gross proceeds" accruing to Century from gas production as defined in 30 C.F.R. § 206.152(h) and 30 C.F.R. § 206.151. As discussed below, the bankruptcy court disagreed.

mary judgment with the bankruptcy court.[19] Century contended that Enron's non-recoupable $12.25 million settlement payment was not royalty-bearing for two reasons. First, the payment was in fact made to extinguish Enron's obligations under the Fixed-Price Contracts. Secondly, the government's royalty claim was barred by the DOI's own acquiescence in the Fifth Circuit decision in *Diamond Shamrock Exploration Corp. v. Hodel* ("*Diamond Shamrock*"), 853 F.2d 1159 (1988), under which non-recoupable take-or-pay payments are never royalty bearing.

On January 17, 1995, the government filed an opposition to Century's motion, claiming that there were material factual disputes regarding the nature of Enron's $12.25 million payment. It also filed an unverified cross-motion for summary judgment claiming that royalties of $1,004,422.70 were then currently due on Enron's settlement payment. On January 20, 1995, the bankruptcy court heard Century's summary judgment motion[20], announced its decision in Century's favor, and indicated that a written decision would follow.

On February 13, 1995, the bankruptcy court issued its findings of fact and conclusions of law with respect to Century's motion.[21] It held that the $12.25 million non-recoupable settlement payment was made solely to extinguish Enron's obligations under the Fixed-Price Contracts, and not for the purpose of obtaining less expensive gas from Century at a later date.[22] In light of this holding, the bankruptcy court

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[19] Century's motion was filed pursuant to Rule 7056 of the Federal Rules of Bankruptcy Procedure, which incorporates Rule 56 of the Federal Rules of Civil Procedure and its pertinent standards.

[20] Only Century's motion was fully briefed at the time of the hearing. Thus, the issues raised only by the government's cross-motion, such as the amount (if any) of its royalty claim, have not been fully briefed or heard by the bankruptcy court or the district court.

[21] App. 37a-52a.

[22] App. 43a.

found that the government's royalty claim was barred by *Diamond Shamrock*, which had established earlier that non-recoupable take-or-pay payments were not royalty bearing under Section 8(a) of OCSLA, 43 U.S.C. § 1337(a).[23] The court further held that for many years after *Diamond Shamrock*, the government -- through amendments to its royalty regulations and through administrative rulings -- had acquiesced in that decision.[24]

b. United States District Court Proceedings

On January 25, 1995, the government appealed the final judgment of the bankruptcy court to Federal District Court for the Western District of Kentucky, contending that the bankruptcy court had improperly granted summary judgment for Century because material facts concerning Enron's settlement payment were in dispute. In addition, the government contended that the district court should reverse the bankruptcy court on the basis of the district court decision in *Independent Petroleum Ass'n of Am. v. Babbit* ("*IPAA*"), Nos. 93-2544, 94-2123 1995 WL 431305 (D.D.C. June 14, 1995), which had

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[23] As construed in *Diamond Shamrock*, "production" for royalty purposes means the actual physical severance of the mineral from the formation. 853 F.2d at 1168. The *Diamond Shamrock* court did not consider non-recoupable take-or-pay payments to be part of the "amount or value of production saved, removed or sold" from the leased premises, as stated by Section 8(a) of the OCSLA, 43 U.S.C. 1337(a). *Id.* at 1163. Rather, the Fifth Circuit held that the non-recoupable payments were compensation to the oil and gas producer for market risks that were not shared by the royalty owner, and thus were not royalty bearing. *Id.* at 1165, 67.

[24] App. 43a-46a. The bankruptcy court additionally concluded that the government's interpretation of the "gross proceeds" rule to require the payment of royalties on Enron's settlement payment would produce the same unreasonable results -- including undeserved royalty windfalls to the government and a distortion of the concept of "fair market value" upon which its royalty regulations are based -- which led the Fifth Circuit in *Diamond Shamrock* to reject an identical interpretation of the "gross proceeds" rule as arbitrary and capricious. App. 48a-50a. The bankruptcy court further found that the government's royalty claim (1) violated the rulemaking requirements of the Administrative Procedure Act ("APA"), 5 U.S.C. § 553, and (2) was unlawfully retroactive. App. 47a, 50a.

held that non-recoupable settlement payments could be royalty bearing in certain instances.[25]

On August 4, 1995, the district court denied the government's appeal.[26] The district court affirmed that the material facts on which Century's motion for summary judgment was based were not in dispute and that those facts established that Enron's $12.25 million non-recoupable settlement payment was made to extinguish its obligations under the Fixed-Price Contracts.[27] In addition, the district court affirmed the bankruptcy court's determination that the government's royalty claim was barred by *Diamond Shamrock*, particularly because the government had acquiesced in that decision.[28] The district court also affirmed the bankruptcy court's rejection of the royalty claim for the additional, independent reasons that (1) such a claim would produce absurd results rendering the "gross proceeds" rule arbitrary and capricious; and (2) the claim was unlawfully retroactive.[29] Accordingly, the district court also granted summary judgment in favor of Century.[30]

c. Proceedings in the United States Court of Appeals for the Sixth Circuit

The government thereafter appealed the district court's decision to the United States Court of Appeals for the Sixth

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[25] As discussed below, the United States Court of Appeals for the District of Columbia later reversed the district court's decision in *IPAA*. *See* 92 F.3d 1248 (D.C. Cir. 1996).

[26] App. 21a-36a.

[27] App. 30a.

[28] App. 30a-31a.

[29] App. 31a-34a. The district court, however, reversed the bankruptcy court's holding that the royalty claim violated the rulemaking requirements of the APA. App. 34a-35a.

[30] App. 36a.

Circuit. While the government's appeal was pending in the Sixth Circuit, the United States Court of Appeals for the District of Columbia Circuit reversed the district court's decision in the *IPAA* case. 92 F.3d 1248 (D.C. Cir. 1996). In its decision, the D.C. Circuit found that the government had acquiesced in *Diamond Shamrock*, which held that non-recoupable take-or-pay payments are not royalty bearing. In light of this fact, the D.C. Circuit found that there was no rational basis for the government's policy of demanding royalties on non-recoupable payments made in settlement of non-recoupable take-or-pay obligations. *Id.* at 1258-60.

Notwithstanding the D.C. Circuit's decision in *IPAA*, on April 14, 1997, the Sixth Circuit issued a decision reversing the summary judgment that had been entered by the bankruptcy court and affirmed by the district court. App. 1a-19a. In that decision, the panel neither reviewed the bankruptcy court's findings of fact under a clearly erroneous standard -- as it was required to do -- nor did it even discuss those findings. Rather, it asserted that in order to determine whether Enron's settlement payment was royalty bearing, it would have to view the transaction "as a whole, as economic reality requires." App. 13a.

The panel then made a *de novo* review of the "whole" transaction -- including both fact and law -- and concluded that Enron's settlement payment was an advance payment for gas, notwithstanding the contrary factual findings of the bankruptcy court.[31] Although there were no factual findings in the record from the proceedings below to support such a conclusion, the panel then held that "the [$12.25 million] payment is royalty-bearing because, like an advance payment, it is tightly linked to 'production sold' later." App. 13a.

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[31] "[W]e hold that the lump sum payment contemplated and was the cause of new gas sales to be delivered in the future, where the parties intended a continuing relationship, and where much of the gas identified in the original contracts was delivered under the replacement contracts. The lump sum payment behaved as an advance payment under a substituted requirements contract." App. 9a.

In its opinion, the panel also reversed the bankruptcy court's conclusion that the government royalty claim was barred by *Diamond Shamrock*. According to the panel, *Diamond Shamrock* did not control the outcome of this dispute and had not been acquiesced in by the government.[32] Moreover, the panel refused to follow the reasoning of the D.C. Circuit in *IPAA*, claiming only that the cases involved different facts. App. 15a.

Petitioner filed a timely petition for rehearing and suggestion for rehearing *en banc* by the Sixth Circuit on June 4, 1997, which was denied on July 23, 1997.

REASONS FOR GRANTING THE PETITION

1. Introduction and Summary

This case presents a simple, discrete and extremely significant question that ought to be decided by this Court: whether a non-recoupable settlement payment made by an oil or gas purchaser to an OCSLA lessee is royalty bearing under Section 8(a) of OCSLA, 43 U.S.C. § 1337(a), particularly in light of certain post-*Diamond Shamrock* regulations and administrative decisions interpreting that statute. In a pleading it filed in connection with the *IPAA* case, the government itself acknowledged the "exceptional" importance of this issue.[33] Specifically, at stake is the "government's ability to secure [, or federal oil and gas lessees' ability to retain,] several hundred millions of dollars in royalties on federal and Indian oil and gas lease production related to roughly *$4.68 billion* worth of contract settlement payments received by federal and Indian lessees between 1986 and 1992" (emphasis added).[34]

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[32] App. 11a-13a.

[33] The government filed a Petition for Rehearing and Suggestion for Rehearing *En Banc* with the D.C. Circuit which was denied on November 21, 1996.

[34] *See id.*

As discussed below, this Court should grant *certiorari* for two primary reasons. First, a uniform, national rule is necessary in light of the direct conflict between United States Courts of Appeals on this issue. Second, regardless of whether a non-recoupable settlement payment is or is not royalty bearing, the Sixth Circuit's decision in this case necessarily rested on factual findings that it was not, as a matter of law, entitled to make.

2. There is a Clear Conflict Among United States Courts of Appeals on This Important Issue of Law

The decision below creates an indisputable conflict between at least two United States Courts of Appeals regarding the administration of federal oil and gas leases. On one hand, the D.C. Circuit, in overturning the district court's decision in *IPAA*, stated unequivocally that the government -- through a consistent string of administrative decisions and regulations -- had acquiesced in the *Diamond Shamrock* decision. 92 F.3d at 1257-58. The D.C. Circuit then held that *Diamond Shamrock*, which firmly established that non-recoupable take-or-pay payments were not royalty bearing, applied with equal force to non-recoupable settlements of future, individual take-or-pay payments. 92 F.3d at 1260.[35] The D.C. Circuit emphasized that the government's right to royalties does not depend on whether a non-recoupable settlement payment can be attributed to gas that is sold after an original gas sales contract is terminated. Rather, the government's right to royalty depends *exclusively* on whether the settlement payment is recoupable or non-recoupable: "[U]nlike the recoupable take-or-pay payment, a nonrecoupable settlement payment is *never* credited as payment for any gas actually severed from the ground." 92 F.3d at 1259 (emphasis in original).

Meanwhile, the Sixth Circuit in this case held that the government had not acquiesced in the *Diamond Shamrock* decision, that *Diamond Shamrock* was not controlling author-

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[35] In light of the government's acquiescence in *Diamond Shamrock*, the D.C. Circuit found that the government "failed to give a nonarbitrary reason for treating the two types of payments differently" as required under APA § 706(2)(A) review. 92 F.3d at 1259.

ity, and that in certain instances, non-recoupable settlement payments *can* be royalty bearing. Specifically, the Sixth Circuit panel held that the non-recoupable $12.25 million settlement payment rendered by Enron to Petitioner Century was in fact royalty bearing because the payment (1) "contemplated and was the cause of new gas sales to be delivered in the future"; and (2) was so "tightly linked" to any production to be purchased under the Spot-Price Contracts that it served the same purpose as an "advance payment" for gas. App. 9a, 13a. The Sixth Circuit therefore embraces the notion that a non-recoupable settlement payment *can* be credited as payment for gas actually severed from the ground -- albeit gas severed at some later date -- and thus *can* be royalty bearing under Section 8(a) of OCSLA, 43 U.S.C. § 1337(a).

The conflict between the Sixth Circuit and D.C. Circuit is readily apparent. Under the Sixth Circuit rule in this case, the recoupability or non-recoupability of a settlement payment is immaterial for purposes of determining whether a royalty is due on such a payment. If a non-recoupable settlement payment acts like an "advance payment for gas," it is royalty bearing. Under D.C. Circuit law as established in *IPAA*, the question of recoupability is not only critical, but dispositive -- a non-recoupable settlement payment is *never* royalty bearing, even if gas is later sold to the party making the non-recoupable settlement payment.

The fact that these two decisions are in such stark contrast is sufficient reason for this Court to grant *certiorari*. In the past, this Court has seen fit to grant *certiorari* merely "to forestall a *possible* conflict in the lower courts" concerning issues of statutory interpretation. *See Dawson Chem. Co. v. Rohm & Haas Co.*, 448 U.S. 176, 185 (1980) (emphasis added). Here, such a conflict already exists and is certain to intensify if left unaddressed. In fact, after the D.C. Circuit issued its opinion in *IPAA* and remanded the case back to district court, the government sought and received an order confirming that it was free to continue to litigate this issue against individual IPAA members in

the hope of prevailing along the lines of the Sixth Circuit's opinion on buyouts in this case.[36]

In another *IPAA* pleading filed after the Sixth Circuit decision in this case, the government itself conceded that "the [MMS] now faces two competing views...in deciding how to proceed on these matters."[37] Absent a uniform, national rule here, federal oil and gas lessees will be either exposed to, or completely immune from, MMS royalty rights on non-recoupable settlement payments depending solely on the jurisdiction in which a royalty claim is litigated. The issue is therefore ripe for this Court's review.

If *certiorari* is granted, petitioner would argue that the government's royalty claim impermissibly exceeds the MMS's statutory, regulatory, and contractual authority. Specifically, Petitioner would assert that the D.C. Circuit correctly found the government's royalty claims on non-recoupable settlement payments to be barred because of its own acquiescence in the Fifth Circuit's *Diamond Shamrock* decision. Petitioner will also show that for many years after *Diamond Shamrock*, both MMS and DOI, through regulatory

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[36] *IPAA* was litigated jointly by plaintiffs Samedan Oil Corporation and the Independent Petroleum Association of America, a large trade association of petroleum businesses and organizations. *See* 92 F.3d at 1253-55. Samedan was seeking review of an MMS royalty assessment of $20,000 on a non-recoupable settlement payment made to Samedan by one of its own gas purchasers. *Id.* The government, desiring a mechanism for a single, national rule on the non-recoupable settlement royalty question, agreed that Samedan's case would proceed as the "test case" for this issue. *Id.* at 1254. However, after the D.C. Circuit's ruling, the government successfully argued to the district court that because of certain jurisdictional defects, the holding of *IPAA* should not apply to individual IPAA members -- except Samedan -- and that the government was free to litigate this same issue against such IPAA members in the D.C. Circuit or anywhere else. *See Independent Petroleum Ass'n of Am. v. Babbit*, 971 F. Supp. 19 (D.D.C. 1997) (granting in part the government's motion for an order implementing the mandate of the District of Columbia Circuit).

[37] MMS' Reply To Plaintiff's Opposition To MMS' Motion for Entry of Order Implementing Mandate of the D.C. Court of Appeals, at 2 (filed May 30, 1997).

amendments and agency case law, *repeatedly* took the position that under the holding of *Diamond Shamrock*, non-recoupable payments of exactly the type at issue in this case were *not* royalty bearing under Section 8(a) of OCSLA, 43 U.S.C. § 1337(a). This Court should therefore ensure that the government defers to its own post-*Diamond Shamrock* interpretation of that statute.[38]

3. The Sixth Circuit Improperly Applied a *De Novo* Standard of Review to the Bankruptcy Court's Findings of Fact

Even if, as the Sixth Circuit has held, non-recoupable settlement payments can be royalty bearing under certain circumstances, the Sixth Circuit panel, in deciding that such circumstances were present in this case, improperly usurped the bankruptcy court's judicial responsibilities by applying a *de novo* standard of review to the bankruptcy court's findings of fact. This Court should accept review to prevent the Sixth Circuit from unabashedly exceeding its appellate authority.[39]

The panel in this case applied a standard of review to the bankruptcy court's factual findings that squarely conflicts with the clearly erroneous standard of review adopted by at least two other panels of the Sixth Circuit.[40] As noted above,

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[38] As the D.C. Circuit noted in *IPAA*, "[u]nder *Chevron* [*U.S.A. Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984)], DOI's interpretation of the gross proceeds rule is held only to a standard of reasonableness, but the interpretation must be reasonable *in light of DOI's adoption of Diamond Shamrock*. Under APA § 706(2)(A) review, the [decision to claim royalties on non-recoupable settlements] must satisfy the arbitrary and capricious standard insofar as it treats contract settlement payments differently from the way it treats take-or-pay payments under *Diamond Shamrock*" (emphasis in original). 92 F.3d at 1258.

[39] Century also believes the Sixth Circuit's factual findings are wholly unsupported by the record. However, even if this were not the case, the Sixth Circuit was not entitled to make *any* findings of fact using a *de novo* standard.

[40] *See In re Moreland*, 21 F.3d 102, 104 (6th Cir. 1994); and *In re Batie*, 995 F.2d 85, 88 (6th Cir. 1993).

on the basis of uncontested evidence submitted by Century, the bankruptcy court found that Enron's settlement payment was made to extinguish its non-recoupable take-or-pay obligations under the Fixed-Price Contracts and, as a result, the settlement payment was *not* an advance payment for gas to be bought at a reduced price under the Spot-Price Contracts. Ignoring these findings, the Sixth Circuit panel engaged in a *de novo* factual review of the "economic reality" of the transaction. App. 13a.

The panel stated in its own opinion that resolution of the government's royalty claim required the panel to decide whether Enron's payment "contemplated and was the cause of new gas sales to be delivered in the future"; and whether the settlement payment was so "tightly linked" to any production to be purchased under the Spot-Price Contracts that it served the same purpose as an "advance payment" for gas. App. 9a, 13a. However, these are the same factual matters the bankruptcy court found to be undisputed when it was decided that the payment was made to extinguish Enron's future take-or-pay obligations. This Court has expressly and repeatedly admonished courts of appeals for engaging in exactly the type of improper, *de novo* fact finding that marks the instant case. *See Icicle Seafoods, Inc. v. Worthington*, 475 U.S. 709 (1986)[41]; *Amadeo v. Zant*, 486 U.S. 214 (1988)[42]. Moreover, the panel's undisputed authority to review conclusions of law

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[41] As this Court noted in *Icicle Seafoods*, "[i]f the Court of Appeals believed that the District Court had failed to make findings of fact essential to a proper resolution of the legal question, it should have remanded to the District Court to make those findings. If it was of the view that the findings of the District Court were 'clearly erroneous' within the meaning of Rule 52(a), it could have set them aside on that basis. If it believed that the District Court's factual findings were unassailable, but that the proper rule of law was misapplied to those findings, it could have reversed the District Court's judgment. *But it should not simply have made factual findings on its own.*" 475 U.S. at 714 (emphasis added).

[42] A district court's lack of precision in factual findings is "no excuse for the Court of Appeals to ignore the dictates of Rule 52(a) and engage in impermissible appellate factfinding." 486 U.S. at 227-28.

de novo did not permit the panel to engage in *de novo* review of factual findings simply because some factual issues in this case may have been intertwined with legal ones.[43] *See In re Batie*, 995 F.2d 85, 88 (6th Cir. 1993) ("if a question is a mixed question of law and fact, then we must break it down into its constituent parts and apply the appropriate standard of review for each part"). For the same reason, the panel cannot justify its findings on the ground that it was entitled to make a *de novo* review of the bankruptcy court's decision to grant summary judgment. If the bankruptcy court erred in finding that material factual matters -- such as whether Enron's settlement payment could be "tightly linked" to future gas sales -- were not in dispute, the proper course of action was to remand the matter to the bankruptcy court for trial rather then to make new appellate findings of fact about the "economic reality" behind Enron's settlement payment.[44]

In sum, this Court should accept review in order to provide much-needed guidance to federal courts, DOI, and all federal oil and gas lessees regarding an important issue of administrative law. In addition, this Court should ensure that petitioner's interests are not unnecessarily and irreparably prejudiced simply because the court of appeals decided to impose its own factual findings by judicial fiat.

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[43] The panel's findings could not possibly be rationalized as purely legal conclusions regarding contract or statutory construction, such as the proper interpretation of the royalty provisions of OCSLA. This royalty dispute, as framed by the Sixth Circuit, requires resolution of at least mixed questions of law and fact, such as whether Enron's payment was "tightly linked" to its purchases under the Spot-Price Contracts.

[44] *See Icicle Seafoods*, 475 U.S. at 714 (if trial court fails to make findings of fact essential to decision, remand is necessary).

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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October 21, 1997

RECOMMENDED FOR FULL - TEXT PUBLICATION
Pursuant to Sixth Circuit Rule 24

ELECTRONIC CITATION: 1997 FED App. 0124P(6th Cir.)
File Name: 97aO124p.06

No. 95-6320

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

In re: CENTURY OFFSHORE MANAGEMENT CORPORATION,

Debtor.

UNITED STATES OF AMERICA,

Plaintiff-Appellant,

v.

CENTURY OFFSHORE MANAGEMENT CORPORATION,

Defendant-Appellee.

ON APPEAL from the United States District Court
for the Eastern District of Kentucky

Decided and Filed April 14, 1997

Before: MERRITT, JONES, and COLE, Circuit Judges.
MERRITT, Circuit Judge.

SUMMARY

This case arises from the bankruptcy of Century Offshore Management Corporation, a natural gas producer and the lessee of federally-owned submerged lands in the Gulf of Mexico. Century sold gas to Enron Gas Marketing, Inc. under five-and five-and-a-half-year, fixed price contracts. The Minerals Management Service of the United States Department of the Interior seeks to obtain $1,855,004 in royalties on a $12,250,000 lump sum payment Enron made to Century to terminate these contracts and replace them with new contracts based on current, floating market prices. The bankruptcy and district courts denied the government's royalty claim because they concluded that the lump sum payment was not a payment for the "production" of gas but merely a settlement payment designed simply to terminate the original contracts. The issue of statutory interpretation before us is whether this lump sum payment is properly attributable to "the amount or value of the production [of natural gas] saved, removed, or sold" under § 1337 of the Outer Continental Shelf Lands Act, 43 U.S.C. §§ 1331-1356 (1996). We conclude that the transaction, viewed as a whole, was clearly linked to gas "production saved, removed or sold," and we therefore reverse the decision of the courts below. An up-front payment made in exchange for a substituted contract that changes the price of the old contract, followed by new purchases, is a sufficient cause of new production of gas to qualify as "production sold" under the Act.

I.

In the Outer Continental Shelf Lands Act (OCSLA), 43 U.S.C. §§ 1331-1356 (1996), Congress authorized the Department of the Interior to issue leases providing for the development of federal oil and gas resources on submerged lands on the outer continental shelf and gave the Department the authority to prescribe rules and regulations necessary to carry out the Act's leasing provisions. 43 U.S.C. § 1334(a) (1996). Since 1982, the Secretary of the Interior has

delegated the administrative responsibility for outer continental shelf leases to the Minerals Management Service.

The Act authorizes the Department of the Interior to grant oil and gas leases to "the highest responsible qualified bidder" and presents a menu of payment approaches from which the Department may choose before the bidding begins. *Id.* § 1337(a)(1). The first of these options -- the one used in the instant case -- provides for a royalty of a fixed percentage of "the amount or value of the production saved, removed, or sold" by the lessee. *Id.* § 1337(a)(1)(A)

The Department of the Interior has the sole authority to prescribe regulations necessary to carry out the provisions of the Act. *Id.* § 1334(a). As part of its administration of the Act, the Department has adopted the "gross proceeds" rule, a broad view of "the amount or value of . . . production." Under the Department's interpretation, "under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing to the lessee for lease production, less applicable allowances." 30 C.F.R. 206.152(h) (1996). The Department has applied the "gross proceeds" rule to offshore leases since its initial implementation of the Act. It has also, in turn, adopted a broad definition of "gross proceeds": "Gross proceeds . . . means the *total monies and other consideration* accruing to an oil and gas lessee for the disposition of the oil [or gas] produced." 30 C.F.R. 206. 151 (1996) (emphasis added).

Century, the debtor in this case, acquired working interests in the leases at issue in this litigation -- known as West Cameron Block 368, South Timbalier Block 107, and Breton Sound Block 53 -- in 1987, 1989, and 1990. All are located in the Gulf of Mexico off the coast of Louisiana. All of these leases incorporate the "amount or value of production saved, removed or sold" language of the statute. ST 107 Lease at 2 (J.A. at 60); WC 368 Lease at 2 (J.A. at 67); BS 53 Lease at 1 (J.A. at 72). Two of the leases -- South Timbalier Block 107 and West Cameron Block 368 -- expressly invoke the "gross proceeds" language of the regulation, stating that the amount

of production "shall not be deemed to be less than the gross proceeds accruing to the Lessee from the sale thereof." ST 107 Lease at 2 (J.A. at 60); WC 368 Lease at 2 (J.A. at 67).

In 1989 and 1990, Century entered into production contracts with Enron Gas Marketing, Inc., under which Enron agreed to purchase gas produced from these leases. First, Enron and Century entered into "base contracts" covering an initial quantity of gas. For the purposes of this case, the base contracts had two important features: They were fixed price contracts, under which Enron agreed to purchase certain minimum quantities of gas for a fixed price; and they contained "take-or-pay" provisions. In other words, Enron was required to pay Century the price of the minimum purchase quantity, even if it did not choose to take any gas.[1] Unlike some standard take-or-pay provisions, these payments for gas not taken were non-recoupable: If Enron were to make a payment for gas not taken one month, and then take more gas than the minimum purchase quantity the next month, the excess gas would not entitle Enron to a refund of a portion of the previous month's payment. In other words, once made, Enron's payments under the take-or-pay clause were gone for good.

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[1] Enron agreed to purchase a minimum quantity of gas each month, defined as follows:

> "Minimum Purchase Quantity", for any Month during the term of this Agreement, shall mean the minimum quantity of Gas, expressed in MMBtus per day, that Buyer is obligated to purchase and receive, or pay for if available and not taken, during such Month, which quantity shall be ninety percent (90%) of the [maximum daily quantity] times the number of days in such month.

Gas Purchase Agreement, South Timbalier Block 107, at 2 (J.A. at 96).

Take-or-pay requirements provide a producer with a minimum cash flow in exchange for reserving its gas production for a purchaser. Take-or-pay requirements are a form of what economists call "demand charges": charges for reserving the option to use. In contrast, charges for the quantity of the gas used are "commodity charges." *See* John S. Lowe, *Defining the Royalty Obligation*, 49 S.M.U. L. REV. 223, 267 (1996).

The base contracts covered a certain minimum quantity of gas. At the same time, Century and Enron entered into "excess contracts" for additional gas produced from the leases in question. In contrast to the base contracts, the excess contracts provided for floating prices tied to the spot price of natural gas. They did not contain take-or-pay provisions.

In late 1991, Enron approached Century with a proposal to purchase the 1989 and 1990 contracts. On February 12, 1992, Enron and Century entered into the agreement that has given rise to the current dispute. Enron agreed to make a lump sum payment to Century of $12,250,000, in return for which Enron was relieved of its obligation to make further payments under the base contracts. At the time of the agreement, Enron did not owe Century any accrued "pay" payments under the take-or-pay clause. Century did not pay royalties to the federal government on any portion of the lump sum payment. But after receiving warnings from its bank about possible royalty liability, Century required Enron to agree to loan Century up to $1.5 million in case the government demanded royalties.

Simultaneously, Enron and Century entered into new contracts, which have become known as the "replacement contracts." These replacement contracts provided for floating prices, fixed to the spot price for natural gas. They did not provide for any minimum quantity, and lacked take-or-pay provisions. The preamble to these contracts expressly noted the parties' "desire to replace and supercede" the previous agreements. *E.g.*, Gas Purchase Contract, Breton Sound Blocks 45 and 52, at 1 (J.A. at 183). Under the replacement contracts, Enron purchased virtually all of the gas identified in the original agreements, within the same time period.

In August of 1992, Hurricane Andrew caused extensive damage to Century's platforms in the Gulf. A year later, it filed for bankruptcy under Chapter 11 of the United States Bankruptcy Code. The United States then filed a proof of claim for $1,855,004, the full royalty that would be due on production worth $12,250,000, the amount of Enron's lump

sum payment. In this adversary proceeding, the United States and Century each filed motions for summary judgment. The bankruptcy court ruled in Century's favor across the board, holding that the government's royalty claim exceeded its statutory authority, and that the government's interpretation of the gross proceeds rule was arbitrary and capricious, unlawfully retroactive, and adopted in violation of the Administrative Procedure Act's notice and comment requirement. The district court affirmed on all grounds except the last.

The government makes several arguments in support of its position that Century owes royalties on the lump sum payment. First, the government notes that courts must defer to an agency's reasonable interpretation of the statutes which it is entrusted to enforce. *See Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984). Within this context, it asserts that Enron made the lump sum payment to obtain a reduced price for future gas purchases. Such an advance payment for future gas, it concludes, would be analogous to an installment payment and clearly linked to the value of production under the statute. It also contends that even if the payment did not serve to obtain a reduced price, it was still "total monies and other consideration" under the government's broad interpretation of the statute and regulations.[2] As a matter of timing, the

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[2] The government contends that even if Century and Enron had not entered into the replacement contracts -- for example, if Enron had "bought out" the original contracts and walked away -- Century would owe royalties on Enron's lump sum payment as it produced (and sold to *other* pipelines or end-users) the gas identified in the original contracts. *See* Appellants' Br. at 12-13; *see also Shell Offshore, Inc.*, MMS-91 0087-OCS (Sept. 2, 1994) at 19; Letter from James W. Shaw, Associate Director for Royalty Management, MMS, to "Payor" (May 3, 1993). We emphasize, for reasons discussed below, that this is not the issue presented in the instant case, where Century and Enron continued their relationship under the replacement contracts. Thus we express no opinion on this aspect of the government's argument.

government seeks royalties on the payment as production occurs under the replacement contracts, not at the time the payment was made.

Century responds that Enron did not make the lump sum payment to reduce the price of future gas purchases. Rather, Century contends, the payment was based on "calculations of the present value of the non-recoupable take-or-pay payments that Enron would owe Century if Enron failed to purchase the minimum gas volumes required during the remaining terms" of the original contracts. Appellee's Br. at 20. Placing emphasis on the fact that Enron was not obligated to take any gas under the replacement contracts, Century characterizes the lump-sum payment as a "buy-out," unrelated for royalty purposes to the simultaneous replacement contracts. Century also contends that the Fifth Circuit's decision in *Diamond Shamrock Exploration Co. v. Hodel,* 853 F.2d 1159 (5th Cir. 1988), supports its position, and is binding on the government through the Minerals Management Service's acquiescence. Century asserts that *Diamond Shamrock* stands for the proposition that royalties are only due on payments made to purchase gas, and that this payment does not fall into that category. Century concludes that the government's current stance is arbitrary, capricious, and inconsistent with prior agency positions. Finally, Century claims that the government's interpretation of the "gross proceeds" rule is unlawfully retroactive.

II.

The government and Century both contend that their respective characterizations of the lump-sum payment flow naturally from the nature of the payment and the circumstances surrounding it. As they frame the issue, we are to determine whether the payment was a "buy-down" of the original contracts' price terms or a "buy-out" of their take-or-pay clauses. Neither characterization adequately and fully describes this payment, however. As the Louisiana Supreme Court stated in *Frey v. Amoco Production Co.,* 603 So.2d 166 (La. 1992): "Total revenue under a gas purchase contract is a

function of quantity and price. . . . Because the producer is willing to negotiate a lower price in exchange for the guarantee the pipeline will either take or pay for a specific minimum quantity of natural gas, the take-or-pay provision effectively lowers the price the producer charges the pipeline per unit of gas." *Id.* at 180. Thus, we decline to advance the fiction that some portion of this payment is clearly allocable to one purpose, and the remainder allocable to another purpose.

The termination of the 1989 and 1990 contracts and the creation of the replacement contracts are one transaction for the purposes of the instant dispute.[3] Their timing and plain language -- including the parties' stated intent to "replace and supercede" the terminated contracts -- make this interpretation the only reasonable conclusion.[4] Viewed in this light, the transaction is akin to a substituted contract, *see* RESTATEMENT (SECOND) OF CONTRACT § 279 (1979), under which Enron agreed to pay Century an advance payment for a new requirements contract. Faced *ab initio* with a simple

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[3] This conclusion stems from our interpretation of the contracts. As such, it is a matter of law subject to *de novo* review by this Court. *First Am. Bank v. Fidelity & Deposit Co.*, 5 F.3d 982, 984 (6th Cir. 1993).

[4] Century's explanation of the parties' intent is not persuasive. Century contends that the amount of the payment represented only the present value of the payments Enron would be required to pay under the take-or-pay provisions of the base contracts. Appellee's Br. at 20. Yet the depositions of employees of Century and its bank, the Bank of Montreal, fail to support this conclusion. Moreover, it is nonsensical on its face: The obligation to make such payments under the take-or-pay clause would have been contingent on Enron not taking any gas. At the very least, this sum would have to be discounted by the probability that Enron would not take any gas. In other words, the parties could not rationally have represented a contingent event in present value terms, without taking into account the likelihood of the occurrence of the contingency. Nothing in the record suggests that Enron had prospectively refused to take any gas under the contract. Indeed, we know that Enron eventually took virtually all the gas identified in the contract. Thus Century's characterization of the parties' intentions respecting the lump sum payment as unrelated to the substitute contract is unacceptable.

requirements contract, we would not examine the monthly payments required under that contract to determine the proportion of the payment allocable to contractual, risk-allocating provisions and separate it from that allocable to pure "price." Similarly, were such a requirements contract to provide for an advance payment rather than monthly payments or payment upon delivery, we would not subject the advance payment to this bifurcated analysis (though the government would not be entitled to its royalties until production). We see no reason to treat this case differently, where we hold that the lump sum payment contemplated and was the cause of new gas sales to be delivered in the future, where the parties intended a continuing relationship, and where much of the gas identified in the original contracts was delivered under the replacement contracts. The lump sum payment behaved as an advance payment under a substituted requirements contract. As a result, the payment was for "production sold" under the statute, and the royalty was payable when the gas was produced.

Diamond Shamrock. The Fifth Circuit's decision in *Diamond Shamrock Exploration Co. v. Hodel,* 853 F.2d 1159 (5th Cir. 1988) is not to the contrary. *Diamond Shamrock* addressed the royalty consequences of take-or-pay payments themselves. The Fifth Circuit applied the same statutes and regulations at issue in the instant case to payments made for gas not taken in two consolidated cases. The court noted that

> [t]he issue raised is whether payments by a pipeline-purchaser to a lessee-producer of a federal oil and gas lease pursuant to a take-or-pay clause in its gas sales contract with the pipeline-purchaser are subject to payment of a royalty when the take-or-pay payment is received, not as value for gas actually taken, but as part of the take-or-pay obligation under the contract.

Id. at 1161. The Fifth Circuit concluded that "royalty payments are not due on take-or-pay payments and are only due on gas actually produced and taken." *Id.* It based its

decision on the fact that the relevant statutes, regulations, and lease provisions all linked royalties to the value of production "saved, removed or sold" from the leased property. "The agency's regulations do not refer to 'gross proceeds' in the abstract," noted the court,

> but only to gross proceeds that accrue to the lessee from the disposition or sale of produced substances, that is, gas actually removed and delivered to the pipeline. Consequently, royalties are not owed unless and until actual production, the severance of minerals from the formation, occurs.

Id. at 1166.

As an initial matter, it is important to note that the primary *practical* consequence of *Diamond Shamrock* was the timing of royalty payments. The contracts before the court allowed the pipelines to take "make-up gas" to obtain rebates of previous take-or-pay payments. For example, consider a hypothetical pipeline that is unable to take gas one month and must make payments under a take-or-pay provision for gas not taken. The next month, it takes the contractually-specified quantity of gas and hence avoids making "pay" payments. But it is also able to take additional gas over this amount. Under the contracts at issue in *Diamond Shamrock*, it would be entitled to a year-end credit equal to the amount of the previously-made take-or-pay payments. When this credit is applied to purchases of gas, it acts as a discount, but the producer still pays royalties based on the contract (or fair market) price. Thus even under *Diamond Shamrock* the government indirectly receives royalties on the take-or-pay payments themselves, but only if and when make-up gas is actually produced and taken.

Our reading of *Diamond Shamrock* suggests that the court interpreted the relevant statutes and regulations to require some nexus with production. Under the facts of that case, that nexus was not achieved until the pipelines took make-up gas. The recoupability provisions of the contracts at issue there allowed the pipelines' take-or-pay payments to be

applied to this make-up gas. This nexus with production then triggered the leases' royalty provisions. This, we believe, is the most rational reading of the occasionally ambiguous *Diamond Shamrock* opinion. *Cf. Independent Petroleum Assoc. of America v. Babbitt*, 92 F.3d 1248, 1259 (D.C. Cir. 1996) (reading *Diamond Shamrock* to require a "link" between payments subject to royalty and the physical severance of gas).

As the above discussion makes clear, we believe the necessary nexus to production exists under the facts of the case before us. Here the simultaneous replacement contracts, under which we know virtually all the previously-identified gas was taken, provide this nexus. Though this gas was not make-up gas, it is analogous to make-up gas in the sense that though it is paid after the payment at issue, it provides a link to production. Now that this gas has been produced and delivered to Enron, royalty payments are due, not merely on the price Enron ultimately paid, but on that price plus the amount of the lump sum payment allocable to the gas ultimately taken.

Acquiescence. We are not persuaded by Century's argument that the government's response to *Diamond Shamrock* foreclosed its approach to the instant case. Because *Diamond Shamrock* is not controlling on this Court, the real issue before us is the extent to which the Minerals Management Service acquiesced in that decision by altering its regulations. After the adverse outcome in *Diamond Shamrock*, rather than appealing the decision or applying it only to those leases within the Fifth Circuit, the government amended its royalty regulations to reflect it. *See* Revision of Gross Proceeds Definition in Oil and Gas Valuation Regulations, 53 Fed. Reg. 45082 (1988). It deleted a prior inclusion of take-or-pay payments as an example in its definition of "gross proceeds," but adopted a very narrow interpretation of the *Diamond Shamrock* decision, expressly noting that the changes were "consistent with, and . . . the minimum necessitated by," the Fifth Circuit's decision. *Id.* at

45084. The ruling, the agency concluded, "requires [the Minerals Management Service] to remove the requirement to pay royalties on take-or-pay payments at the time the payment is made. Of course, royalties are still due when make-up gas is taken." *Id.* at 45083.

The government never conceded, however, that it would not seek royalties once a sufficient link to production is established. *Diamond Shamrock* makes it clear that courts should look, *ex post*, at whether certain actions create a nexus with production. In *Diamond Shamrock*, unlike the instant case, one piece of paper established recoupability and hence the necessary nexus with production. Here, we are faced with two pieces of paper, which Century characterizes as independent. But again, we are construing them together, as one transaction. Together, they provide a nexus between the lump sum payment and later production. Now that production has taken place, the government is entitled to its royalties. It is true that Enron was not absolutely obligated to take gas under the replacement contracts. But Enron did eventually take most or all of the gas. Similarly, in the recoupable take-or-pay payment situation addressed in *Diamond Shamrock*, the pipeline was not required to take make-up gas, though that action was what triggered the refunds -- and as the opinion makes clear, royalties.

As discussed above, we view this transaction, taken as a whole, as an advance payment for gas. In response to *Diamond Shamrock*, the Minerals Management Service also amended its rules for advanced payments, noting that

> [i]n view of the Fifth Circuit's ruling that royalty is not owed until make-up gas is actually produced and taken, it follows that no royalty is due on advanced payments until the specific gas which repays the advanced payment actually is produced.

Id. In the instant case, that gas has been produced, and a royalty is now due.

Finally, we note alternatively that it is difficult to see why this payment was not for production "saved" under the

language of the statute. Viewing the transaction as a whole, as economic reality requires, it seems clear that the payment was made to ensure a ready source of gas for Enron under the replacement contracts. As such, this production would be "saved" for Enron's use -- the very language used in the statute. Neither party advances this argument, however, and so we hold that the payment is royalty-bearing because, like an advanced payment, it is tightly linked to "production sold" later. Thus, we do not rest our holding on this ground.

III.

We do not find compelling the "absurd results" that the lower courts fear would result from the outcome we reach. First, the district court argues that the government's interpretation of gross proceeds "would necessitate two royalty payments for one sale of natural gas in almost every case where the producer sells natural gas after the original contract is terminated." Opinion and Order at 11 (J.A. at 49). It is true that Century would have to pay one royalty in two components. But we fail to see how this procedure presents a problem. No double-counting would result. Indeed, the *Diamond Shamrock* opinion, on which the district court otherwise relies, contemplates a similar result. Under *Diamond Shamrock*, when a purchaser receives a discount for make-up gas, the producer must still pay a royalty on the gas's contract or market value. This royalty is in essence also one royalty with two components: One based on the discounted price currently received for make-up gas, and one based on the difference between the discounted price and the market or contract price.

Second, the district court notes that "as recognized by the court in *Diamond Shamrock*, the purpose of the minimum take requirements is to apportion risk between the buyer and seller of the natural gas by compensating the producer, not the owner of the minerals, for the risks associated with development and production." *Id.* at 12 (J.A. at 50). It is true that the *Diamond Shamrock* court made this observation. However, there can be no serious contention that the

government acquiesced in this portion of the opinion. In addition, of course, this argument does not respond to the possibility that some or all of the payment was made to obtain lower future prices. Moreover, the district court's risk bearing conclusion is not persuasive. While it is true that take-or-pay provisions shift the risk of very low prices or low market liquidity to the buyer, which must make a minimum payment regardless of its ability to take the gas, the allocation of risk between the seller/lessee and the lessor is not as clear. A lessor receives diminished royalties from diminished exploration, production, and development. The mineral exploitation of its land involves the risk of opportunity costs, such as foregone profits from alternative uses of the land, that are borne solely by the lessor. *Cf. Frey v. Amoco Production Co.*, 603 So.2d 166, 178 (La. 1992) ("[I]t is a myopic eye which perceives the lessor as sharing none of the risks associated with bringing the gas to the ground...."), cited with approval in *Klein v. Jones*, 980 F.2d 521, 530 (8th Cir. 1992). A lease/royalty arrangement actually lies somewhere in the middle on the risk-allocation continuum. *Cf. Henry v. Ballard & Cordell Corp.*, 418 So.2d 1334, 1338 (La. 1982) ("Where the mineral lease provides for payment to the lessor of a fractional royalty interest, the lease arrangement is in the nature of a cooperative venture."). An outright sale -- or more realistically, a fixed-amount lease without royalties -- would have shifted more of the risks of production away from the government. Under a joint production venture, on the other hand, the government would have borne more of these risks. Thus, the district court's risk-allocation concern is not dispositive and merely begs the question at issue here. The district court's risk bearing theory is particularly unpersuasive when transferred from private parties, *see Diamond Shamrock* at 1167, to the federal government. The federal government has reasons for choosing not to act as an oil company that do not apply to private actors.

The District of Columbia Circuit's decision in *Independent Petroleum Association of America v. Babbitt*, 92 F.3d 1248 (D.C. Cir. 1996), does not compel a different

result. In *Independent Petroleum Association*, the court addressed the royalty implications of a settlement payment made to Samedan Oil Corporation, a lessee of a natural gas well on Indian lands, in exchange for a compromise of accrued and prospective take-or-pay liabilities. Samedan and the purchaser, Southern Natural Gas Company, agreed to a "complete buyout." On the same day, Samedan contracted to sell the gas that was the subject of the contract with Southern to a third party. Thus *Independent Petroleum Association* addressed a situation in which a nexus with production did not exist. *See Independent Petroleum Assoc.* at 1259-60 (construing *Diamond Shamrock* to require a "link" between royalties and physical severance). It is not at all clear how the *Independent Petroleum Association* court would have dealt with the instant case, where Enron's eventual purchase under the terms of a simultaneous replacement contract of virtually all the gas at issue provides a sufficient nexus to production to support the government's royalty claim.

Century seems to suggest that a holding in favor of the government would provide a disincentive for producers and pipelines to settle accrued take-or-pay obligations or to buy out onerous take-or-pay provisions. This contention is without merit: Our holding simply requires lessees to share these payments when they are sufficiently linked to production. Indeed, in this case, Century accepted the lump sum payment and replacement contract prices despite its own uncertainty about the royalty implications of the deal. The producer will still choose to produce, at least over the short run, because it receives a marginal gain -- it just shares it with the owner of the land. In addition, contrary to Century's contention, the prices it receives are no less "market" prices simply because they must reflect Century's obligations to its lessor.

It is important to remember that Century and other producers do not own the land that is the subject of these leases. In passing the Outer Continental Shelf Lands Act, Congress declared that "the outer Continental Shelf is a vital national

resource reserve held by the Federal Government for the public, which should be made available for expeditious and orderly development, subject to environmental safeguards, in a manner which is consistent with the maintenance of competition and other national needs." 42 U.S.C. § 1332 (1996). In opening these lands up for development, Congress created an opportunity for oil producers such as Century, but did not pull its hand away completely. The passage quoted above and the statute as a whole make it clear that the outer continental shelf is a special area in which the government retains a continuing interest. That the government chose not to simply walk away, cash in hand, from the production of resources on the outer shelf is demonstrated by these very leases, which provide for royalties linked to production rather than fixed payments. The government holds these lands "for the public'" and as such owes duties to all its citizens. This includes consumers and those who navigate, fish, and enjoy the beauty of the lands, not solely those who help the government exploit the lands' resources. *Cf.* William H. White, *The Right to Recover Royalties on Natural Gas Take-or-Pay Settlements,* 41 OKLA. L. REV. 663, 674 (1988) (acknowledging the argument that "[t]ake-or-pay receipts are created by the lease and the productive capacity of the property. The lessee would have no basis to obtain take-or-pay benefits but for the lease.").

IV.

Retroactivity. Century claims that the government's demand for royalties is unlawfully retroactive. The lower courts both agreed with Century on this independent ground. Century argues that the government announced and applied its current approach to royalties for contract settlements in two administrative cases imposing royalty obligations on settlements of take-or-pay obligations or contractual provisions, *Shell Offshore, Inc.*, MMS-91-0087-OCS (Sept. 2, 1994) and *Samedan Oil Corp.* MMS-94-0003-IND (Sept. 16, 1994). Because this approach was a departure from settled practice at the time, concludes Century, it should not apply to

the lump sum payment in the instant case, which occurred in early 1992. We disagree.

In *Sun Exploration and Production Co.*, 112 I.B.L.A. 373 (1990), the Interior Board of Land Appeals restricted the ability of the Minerals Management Service to depart from a previous administrative position and apply a new approach retroactively. The threshold question is whether the Minerals Management Service's construction of the gross proceeds rule in these cases was "an abrupt departure from a well-established practice," in which case retroactive application is restricted, or merely "an attempt to fill a void in an unsettled area of the law." *Id.* at 392.

In support of its argument that *Shell Offshore* and *Samedan* represented departures from established practice, Century points to the fact that the Minerals Management Service amended its royalty provisions in response to the *Diamond Shamrock* opinion, and asserts that during the following five years the Service "consistently and repeatedly disclaimed royalties on non-recoupable settlement payments." Appellee's Br. at 45. In response, the government claims that the Department of the Interior had made no "final" or "definitive" pronouncement on the subject. Appellant's Br. at 47.

We hold that the government's decision to seek royalties in this case, and its decisions in *Shell Offshore* and *Samedan*, were not abrupt departures from well-established practice. The contrary agency positions cited by Century are not applicable to these facts. For example, Century refers to an internal memorandum dated November 30, 1990, in which a Minerals Management Service official considered a possible refund of royalties paid by Chevron, U.S.A. after Chevron received a "buy-out" payment from a gas purchaser. Letter from Milton K. Dial, Chief of Royalty Valuation and Standards Division, MMS, to Chief of Fiscal Accounting Division, MMS (Nov. 30, 1990). The memorandum states that "contract 'buy-out' payments received by a producer to free a purchaser from future obligations under a sales contract are not associated with production removed from the lease and, therefore, will not be

subject to royalty." *Id.* Century asserts that it had a right to rely on this language when it participated in the transactions at issue in the instant case.

But, as outlined above, this case involves more than a purchaser buying out a contract and walking away from the relationship. Here, the contemporaneous replacement contracts make this transaction more akin to a buy-down, notwithstanding the parties' characterization. The Chief of Royalty Valuation's memo makes clear that buy-downs and buy-outs are to be treated differently. His memo defines a buy-out payment as one "not associated with production removed from the lease." *Id.* In contrast, we have held here that by taking the same gas under the replacement contracts, Enron provided a sufficient association with production.[5] In addition, as noted above, we believe *Diamond Shamrock* implies this conclusion. Thus we hold that at the very least the government's position here and in *Shell Offshore* and *Samedan* is merely "an attempt to fill a void in an unsettled area of the law."

V.

Notice and comment requirement of the Administrative Procedure Act. On this issue the district court overturned the ruling of the bankruptcy court. We agree with the district court's holding that the government's issuance of *Shell Offshore* did not violate the notice and comment requirement of the Administrative Procedure Act, 5 U.S.C. § 553(b) (1996). Though an agency is ordinarily required to provide notice and an opportunity for comment before adopting a new rule, *id.*, notice and comment are not necessary when the agency issues "interpretive rules." *Shalala v. Guernsey Memorial Hospital,* 115 S. Ct. 1232, 1239 (1995). An

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[5] Notably, the memorandum also cautioned that the circumstances leading to a contract 'buy-out' payment and the agreements under which it is made must be reviewed to ensure that payment is tendered only in consideration of the contract termination." *Id.*

interpretive rule is one "issued by an agency to advise the public of the agency's construction of the statutes and rules which it administers." *Id.* We agree with the district court that *Shell Offshore* "advises the public of the DOI's construction of OCSLA and the gross proceeds rule as applied to contract settlement payments," and hence that notice and comment were not required. In addition, in light of our holding that the government's approach to royalties here and in *Shell Offshore* is not an abrupt departure from well-established practice, we doubt that it is a new rule in any case.

CONCLUSION

For the foregoing reasons, we disagree with the district court's conclusion that the government is not entitled to a royalty on the portion of the lump sum payment allocable to gas produced under the replacement contracts. We agree that the government's actions did not violate the Administrative Procedure Act. Accordingly, the district court's judgment is REVERSED in part and AFFIRMED in part, and the case is REMANDED to the district court, which should determine the royalty due in accordance with this opinion.

No. 95-6320

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

FILED
JUL 23 1997
LEONARD GREEN, Clerk

IN RE: CENTURY OFFSHORE MANAGEMENT CORPORATION,

Debtor,

UNITED STATES OF AMERICA,

Plaintiff-Appellants,

v.

CENTURY OFFSHORE-MANAGEMENT CORPORATION,

Defendant-Appellee.

ORDER

BEFORE: MERRITT, JONES, and COLE, Circuit Judges.

The court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active judges of this court, and no judge of this court having requested a vote on the suggestion for rehearing en banc, the petition for rehearing has been referred to the original panel.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the case. Accordingly, the petition is denied.

ENTERED BY ORDER OF THE COURT
/s/ Leonard Green
Leonard Green, Clerk

UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF KENTUCKY
LEXINGTON

CIVIL ACTION NO. 95-116

Eastern District of Kentucky
FILED: AUG 4, 1995
AT LEXINGTON
LESLIE G. WHITMER
CLERK: U.S. DISTRICT COURT

IN RE: CENTURY OFFSHORE MANAGEMENT CORP.
BANKRUPTCY CASE NO. 93-5-1340

Debtor.

UNITED STATES OF AMERICA,

Appellant,

v.

CENTURY OFFSHORE MANAGEMENT CORPORATION,

Appellee.

OPINION AND ORDER

* * * * * * * * * * * * * * *

The United States of America, on behalf of the U.S. Department of the Interior, Bureau of Minerals Management Service ("MMS"), seeks to appeal the bankruptcy court's order of February 13, 1995, granting the motion of the appellee, Century Offshore Management Corporation ("Century"), for summary judgment and denying the United States' cross-motion for summary judgment.

I. FACTS AND PROCEDURAL BACKGROUND

Prior to filing for bankruptcy under Chapter 11 of the United States Bankruptcy Code on August 23, 1993, Century entered into several oil and gas leases issued by MMS

pursuant to the Outer Continental Shelf Lands Act ("OCSLA"), 43 U.S.C. § 1331, *et seq.*, and the regulations promulgated thereunder. The leases are located in offshore federal waters adjacent to Louisiana on the Outer Continental Shelf ("OCS") in the Gulf of Mexico. Among the OCS leases held by Century are the leases commonly known as the South Timbalier Block 107 Lease ("ST 107"), the West Cameron Block 368 Lease ("WC 368"), and the Breton Sound Block 53 Lease ("BS 53"). Century also entered into leases of two offshore blocks leased by the State of Louisiana, commonly known as the Breton Sound Block 52 Lease ("BS 52") and the Breton Sound Block 45 Lease ("BS 45"). Under the OCSLA, the United States is entitled to receive a royalty payment from the federal lessees equal to a fixed percentage of the amount or value of the production saved, removed or sold.

In 1989 and 1990, Century and Enron Gas Marketing, Inc. ("Enron") entered into several gas purchase contracts under which Enron agreed to purchase certain minimum quantities of natural gas produced by Century from the ST 107 Lease, the WC 368 Lease, and the BS 53 Lease. Under the Gas Purchase Agreement executed on December 20, 1989 (the "ST 107 Base Contract"), Enron agreed to purchase a certain minimum quantity of natural gas each month that could not be less that the "Minimum Purchase Quantity" as defined in Section 1.1 of the ST 107 Base Contract, which provides:

> "Minimum Purchase Quantity", for any month during the term of this Agreement, shall mean the minimum quantity of Gas, expressed in MMBtu per day, that Buyer is obligated to purchase and receive, or pay if available and not taken, during the month, which quantity shall be ninety percent (90%) of the MDQ [Maximum Daily Quantity] times the number of days in such month.

If Enron failed to purchase that minimum quantity of natural gas in any month, Enron was required to make non-recoupable payments to Century, pursuant to Section 3.4 of

the ST 107 Base Contract ("take-or-pay payments"). The ST 107 Base Contract, originally effective through March 31, 1996, was subsequently extended through October 31, 1996.

Similarly, under the Gas Purchase Agreement executed on March 27, 1990 (the "WC 368 Base Contract"), Enron agreed to purchase certain minimum quantities of natural gas produced by Century from the WC 368 Lease, the BS 45 Lease, and the BS 52 Lease on a monthly basis. Under Section 3.4 of the WC 368 Base Contract, Enron also agreed to make non-recoupable take-or-pay payments to Century in any month in which Enron failed to purchase that minimum quantity of natural gas. The term of the WC 368 Base Contract extended through September 30, 1995.

Due to a decline in the market price for gas, Enron informed Century in November 1991 that it wished to purchase the natural gas contracts between Century and Enron covering the ST 107, WC 368, and BS 53 leases. Century and Enron each prepared calculations of the present value of the payments that Enron would be required to make under the contracts during their remaining terms if Enron failed to purchase the minimum quantities of natural gas required by the ST 107 and WC 368 Base Contracts and instead paid Century the non-recoupable payments required by Section 3.4 of the ST 107 and WC 368 Base Contracts for failure to make those purchases. As a result of their calculations and negotiations, Century and Enron entered into a settlement agreement on February 12, 1992, whereby Enron made a lump sum, non-recoupable payment to Century of $12,250,000.00 and Enron was relieved of any obligation to make any further payments under the ST 107 and WC 368 Base Contracts as of January 1, 1992 (the "Enron settlement"). Century did not pay royalties to the federal government on any portion of that lump sum payment.

On February 11, 1994, the MMS filed a proof of claim alleging that it is the holder of an unsecured priority claim in the amount of $1,855,004.00 as oil and gas royalties on the Enron settlement. In support of its claim, the MMS alleges

that as a result of Century's receipt of the lump sum payment from Enron, and by failing to pay its alleged royalty obligation, Century breached its lease agreement with the MMS. Century filed its objections to the MMS' proof of claim on May 13, 1994, denying that any mineral royalties are due.

On December 16, 1994, Century filed a motion for summary judgment seeking disallowance of the MMS' proof of claim, arguing that the MMS is not entitled to royalties on a contract settlement payment that Enron made to Century in order to terminate Enron's future obligations under the gas purchase contracts with Century. On January 17, 1995, the United States filed an opposition to Century's motion for summary judgment, and also filed a cross-motion for summary judgment seeking allowance of the MMS' proof of claim in the amount of $1,004,422.70, plus additional royalty payments of unspecified amounts which are allegedly due through September 30, 1995.

At a hearing held on January 20, 1995, the bankruptcy court ruled from the bench to sustain Century's motion for summary judgment and to overrule the United States' cross-motion for summary judgment. Thereafter, on February 13, 1995, the bankruptcy court entered a final judgment in favor of Century and issued a written opinion with findings of fact and conclusions of law. The United States filed its notice of appeal of January 27, 1995.

II. THE BANKRUPTCY COURT'S ORDER

The bankruptcy court based its decision to grant Century's motion for summary judgment on several grounds. First, the bankruptcy court considered the statutory, regulatory, and contractual authority upon which the MMS based its royalty claim. The bankruptcy court adopted the Fifth Circuit Court of Appeal's interpretation of the term "value of production" in *Diamond Shamrock Exploration Corp. v. Hodel*, 853 F.2d 1159, 1168 (5th Cir. 1988) and determined that under Section 8(a) of OCSLA, the regulations promulgated thereunder, and the OCS leases themselves,

royalties are due on OCS leases only when there has been actual production, "meaning the severance of the minerals from the producing underground formation."

Applying that analysis to the present case, the bankruptcy court held that Enron's payment of $12,250,000.00 to Century was to terminate Enron's future obligations under the ST 107 and WC 368 Base Contracts to make non-recoupable payments to Century when Enron failed to purchase certain minimum quantities of natural gas, not for the severance of natural gas. In other words, the payment was "not a price paid for either present or future deliveries of severed hydrocarbons to Enron." Consequently, the bankruptcy court held that, under OCSLA, the regulations promulgated thereunder, and the OCS leases, Enron's settlement payment to Century is not royalty bearing. Because the MMS' royalty claim is based on an interpretation of gross proceeds which exceeds its statutory, regulatory, and contractual authority, the bankruptcy court granted Century's motion for summary judgment and denied the United States' cross-motion for summary judgment.

The bankruptcy court further determined that the MMS' royalty claim is based on an interpretation of "gross proceeds" that is arbitrary and capricious. Specifically, the bankruptcy court determined that allowing the MMS' royalty claim would require the lessee to make two royalty payments on one sale, would provide a windfall benefit to the government, would unfairly deprive producers of admitted royalty overpayments, and would distort the concept of "fair market value" on which the royalty regulations are based.

Next, the bankrupt court held that the MMS' interpretation of "gross proceeds" on which it relies was not adopted in compliance with the rulemaking requirements of the Administrative Procedure Act ("APA"), 5 U.S.C. § 553. According to the bankruptcy court, the royalty values, as set out in *Shell Offshore, Inc.*, Docket No. MMS-91-0171-OCS, must be rejected for failure to comply with the notice and comment provision of the APA.

Finally, the bankruptcy court determined that MMS' new interpretation of "gross proceeds" should not be given retroactive effect based on the criteria established by the Department of Interior in *Sun Exploration and Production Co.*, 112 IBLA 373 (1990), in which the Interior Board of Land Appeals sharply limited the circumstances in which MMS may apply a new interpretation of a regulation retroactively. Based on *Sun Exploration*, the bankruptcy court concluded that even if the MMS' interpretation is otherwise lawful, the MMS' interpretation is unlawfully retroactive.

III. ISSUES FOR REVIEW

The United States has presented two issues for appeal:

1. Whether the bankruptcy court erred in sustaining Century's motion for summary judgment?

2. Whether the bankruptcy court erred in denying the United States' cross-motion for summary judgment?

IV. STANDARD FOR REVEW

Rule 56 of the Federal Rules of Civil Procedure applies in adversary proceedings. Fed. R. Bankr. P. 7056. Pursuant to Rule 56, summary judgment is appropriate if the moving party establishes that there is no genuine issue of material fact for trial and that it is entitled to judgment as a matter of law. *See Celotex Corp. v. Catrett*, 477 U.S. 317 (1986). The Court must consider all pleadings, depositions, affidavits, and admissions on file and draw reasonable inferences in favor of the party opposing the motion. *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986); *see Smith v. Hudson*, 600 F.2d 60 (6th Cir.), *cert. dismissed*, 444 U.S. 986 (1979).

Once the moving party shows that there is an absence of evidence to support the nonmoving party's case, the nonmoving party has the burden of coming forward with evidence raising a triable issue of fact. *Celotex Corp.*, 477 U.S. at 324. To sustain this burden, it may not rest on the mere allegations of its pleadings. Instead, it must set forth

specific facts showing that there is a genuine issue for trial. *Potter's Med. Center v. City Hosp. Ass'n.*, 800 F.2d 568 (6th Cir. 1986). Ultimately, the standard for determining whether summary judgment is appropriate is "whether the evidence presents a sufficient disagreement to require submission to a jury or whether it is so one-sided that one party must prevail as a matter of law." *Booker v. Brown & Williamson Tobacco Co.*, 879 F.2d 1304, 1310 (6th Cir. 1989) (quoting *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 251-52 (1986)).

Review of an order of the bankruptcy court granting summary judgment is *de novo. See, e.g., Berlin v. Michigan Bell Tel. Co.*, 858 F.2d 1154, 1161 (6th Cir. 1988). Based on a *de novo* review of the record and applying the Rule 56 standards, the Court determines that the bankruptcy court was correct as a matter of fact and law in granting Century's motion for summary judgment and denying the United States' motion for summary judgment.

V. THE BANKRUPTCY COURT DID NOT ERR IN GRANTING CENTURY'S MOTION FOR SUMMARY JUDGMENT

A. THE ROYALTY CLAIM EXCEEDS THE MMS' STATUTORY, REGULATORY, AND CONTRACTUAL AUTHORITY

The bankruptcy court correctly concluded that the MMS' royalty claim exceeds the statutory, regulatory, and contractual authority of the MMS. Section 8(a) of OCSLA provides that the United States is entitled to a royalty based on a percentage of the "amount or value of the production saved, removed, or sold" from the leased premises. 43 U.S.C. § 1337(a). Pursuant to OCSLA, the Department of the Interior ("DOI") has promulgated regulations, which interpret Section 8(a). Specifically, 30 C.F.R. § 206.152(h) -- the "gross proceeds rule"-- provides:

> Notwithstanding any other provision of this section, under no circumstances shall the value of production for royalty purposes be less than the gross proceeds accruing

> to the lessee for lease production, less applicable allowances determined pursuant to this subpart.

The royalty provisions of the ST 107, WC 368. and BS 53 leases essentially track the language of Section 8(a) and the gross proceeds rule. Section 6(b) of the OCS Leases including the leases at issue in this proceeding, provides in relevant part:

> [T]he value of production for the purposes of computing royalty shall not be deemed to be less than the gross proceeds accruing to the Lessee from the sale thereof.

Construing the term "value of production," the Fifth Circuit Court of Appeals in *Diamond Shamrock Exploration Corp. v. Hodel*, 853 F.2d 1159, 1168 (5th Cir. 1988), determined that production is defined as the actual physical severance of the mineral from the formation.

Under the ST 107 and WC 368 Base Contracts, Enron agreed to purchase certain minimum quantities of gas from Century each month; failure to purchase that minimum quantity resulted in Enron's obligation to make non-recoupable payments to Century. While negotiating the settlement agreement, Enron and Century calculated the non-recoupable payments that Enron would have made to Century during the period of the Base Contracts in the event that Enron failed to purchase the minimum monthly quantities of gas as required by the Base Contracts. Based on these calculations, Enron and Century agreed that Enron would pay $12,250,000.00 to Century. In return, Century would extinguish Enron's future obligations under the Base Contracts.

Although the bankruptcy court determined that Enron's settlement payment was not for natural gas but rather to terminate the gas purchase contracts, the MMS argues that it is "permissible" under the gross proceeds rule for the government to treat Enron's settlement payment as a prepayment to purchase natural gas in the future from the covered leases. Consequently, the MMS argues that the Court should defer to the government's interpretation of the gross

proceeds rule pursuant to the rules of statutory construction set out by the Supreme Court in *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984). According to *Chevron*, when a court reviews an agency's interpretation of a statute authorizing administration of the agency's programs, the "question for the court is whether the agency's answer is based on a permissible construction of the statute."

The MMS relies on its interpretation of the gross proceeds rule as set forth in *Shell Offshore, Inc.*, Docket No. MMS-91-0171-OCS (September 2, 1994) and *Samedan Oil Corp.*, Docket No. MMS-94-0003-IND (September 16, 1994). In *Shell Offshore*, the Assistant Secretary ruled that payments under contract settlements are royalty bearing if and when there is production of the gas to which the payments are attributable. However, if no gas is produced, the lessee does not owe royalties to the government. In *Samedan*, the lessee, Samedan Oil Corporation ("Samedan"), appealed the decision of the MMS which assessed $20,000.00 in royalties against Samedan to the Assistant Secretary for the DOI. Samedan and Southern Natural Gas ("Southern") entered into a gas purchase contract in 1981 which contained take-or-pay provisions which required Southern to pay for a minimum quantity of gas each year, even if it did not take that amount. However, to the extent that Southern purchased gas in excess of the specified minimum in a given year, it could credit payments for gas not taken over the five preceding years against the purchase of an equivalent quantity of the current year's excess. As a result of the decline in both the sales and market price of natural gas, Samedan and Southern entered into a settlement agreement on December 1, 1987 whereby Southern was released from all past and future obligations under the 1981 contract and Southern paid Samedan $100,000.00.

On December 2, 1987, the MMS issued an order requiring Samedan to pay $20,000.00 in royalties based on the settlement. This order was appealed to the Assistant

Secretary of the DOI. In an opinion affirming the MMS' decision, the Assistant Secretary held that Southern's buyout payment was subject to a royalty when production of the bought out volumes occurred and the gas was sold to subsequent purchasers at a discounted price.

The MMS argues that this Court should defer to its interpretation of "gross proceeds," as set out in *Shell Offshore* and *Samedan*, and require that Century pay a royalty to the government on Enron's payment that was made in compromise of non-recoupable take-or-pay payments. As pointed out by the bankruptcy courts however, there is no need or obligation for this Court to defer to an agency decision when a court has already issued a definitive interpretation of the statute, the implementing regulations, and the relevant contract provisions. *NationsBank of North Carolina v. Variable Annuity Life Insurance Co.*, 998 F.2d 1295 (5th Cir. 1993). Not only has the court *in Diamond Shamrock* interpreted Section 8(a) of OCSLA and the gross proceeds rule contained in the regulations, but the MMS has amended the royalty regulations to conform to that interpretation. Therefore, it is not necessary for the Court to defer to the agency's interpretation of "gross proceeds" as set forth in *Shell Offshore* and *Samedan.*

Even if deference was appropriate, the Court would be required to reject the MMS' interpretation of "gross proceeds" as impermissible. Enron's payment to Century was not for present or future deliveries of severed natural gas to Enron; rather it was to terminate Enron's future obligations under the ST 107 and WC 368 Base Contracts. According to Section 8(a) of OCSLA and the gross proceeds rule, as well as the language contained in the royalty provisions of the OCS leases, royalties are due only where there has been production, meaning the severance of minerals from the producing underground formation. A royalty is not due on a take-or-pay payment because that payment was not made for severed gas but rather because the purchaser failed to purchase gas. *Diamond Shamrocks*, 853 F.2d at 1167-68. By

interpreting "gross proceeds" to include payments made not for natural gas but rather to terminate a contractual obligation, the MMS exceeded its statutory, regulatory, and contractual authority and, therefore, the MMS' interpretation of "gross proceeds" is impermissible. As no genuine issue of material fact exists on this issue, the bankruptcy court correctly granted Century's motion for summary judgment and denied the United States' cross-motion for summary judgment.

B. THE ROYALTY CLAIM IS BASED ON AN INTERPRETATION OF THE GROSS PROCEEDS RULE THAT IS ARBITRARY AND CAPRICIOUS

The bankruptcy court also determined that the MMS' royalty claim is based on an interpretation of the gross proceeds rule that is arbitrary and capricious. This court agrees with the bankruptcy court for several reasons. First, the MMS' interpretation of gross proceeds would necessitate two royalty payments for one sale of natural gas in almost every case where the producer sells natural gas after the original contract is terminated. *See Diamond Shamrock*, 853 F.2d at 1166. Not only would the producer be required to pay one royalty based on the proceeds received for the sale of natural gas under a successor contract, but the producer must also pay a second royalty on the same sale based on the portion of the settlement payment which the MMS allocates to that sale.

Second, as recognized by the court in *Diamond Shamrock*, the purpose of the minimum take requirements is to apportion risk between the buyer and seller of the natural gas by compensating the producer, not the owner of the minerals, for the risks associated with development and production. *Id.* at 1167. According to *Diamond Shamrock*:

> [T]his is the precise reason for entering into a lease agreement. The government leases oil producing lands in order to, among other things, reap the benefits, through royalty payments, without having to shoulder the

> associated risks of exploration, production and development.

Id. It would be irrational to let the government share in any revenues that the producer realized by taking those market risks while simultaneously protecting the government from any and all losses suffered by the producer as a result of taking those same risks.

Third, the court in *Diamond Shamrock* also determined that the position put forth by the MMS could in some cases unfairly deprive producers of refunds of admitted royalty overpayments, resulting in a windfall to the government. *Id* at 1166. Under OCSLA, a producer only has two years in which to seek a royalty refund of a royalty overpayment made on a federal offshore lessee. 43 U.S.C. § 1339. On the other hand, the government claims to have broad discretion to reallocate a settlement payment among the various issues settled and/or among the various leases covered by the settlement. Thus, the government may delay challenges of this type until after the two year time limit on refunds has expired. Consequently, in many instances, producers could lose the right to a refund of an admitted royalty overpayment merely because of the government's lack of diligence in pursuing this type of claim.

Finally, the MMS' interpretation of "gross proceeds" distorts the concept of "fair market value" on which the government's royalty regulations are based. According to the MMS, a payment made to terminate future obligations under a gas purchase contract is part of the "market value" of natural gas that will be produced and sold at a later time to the same or a different purchaser. But if the purchaser does not take gas under the original gas purchase contract, there is no market for that gas. Thus, it is nonsensical to claim that any portion of the settlement payment is part of the "fair market value" of gas sold at a later time under a different contract.

The government's claim in this case is based on an interpretation of "gross proceeds" which produces the same unsound and untenable results which troubled the court in *Diamond Shamrock*. Thus, the bankruptcy court correctly

determined that the MMS' royalty claim is based on an interpretation of "gross proceeds" which is arbitrary and capricious.

C. THE ROYALTY CLAIM IS UNLAWFULLY RETROACTIVE

The bankruptcy court further determined that the MMS' royalty claim is based on an interpretation of "gross proceeds" that is unlawfully retroactive under the criteria established by the MMS in *Sun Exploration and Production Co.*, 112 IBLA 373 (1990). The interpretation upon which the MMS relies was issued in *Shell Offshore* more than two years after the settlement between Century and Enron and more than seven months after the MMS filed its royalty claims in this case

In *Sun Exploration*, the Interior Board of Land Appeals ("IBLA") sharply limited the circumstances in which the MMS may apply a new interpretation of a regulation retroactively. Specifically, the IBLA held that when the MMS departs from a prior administrative position and seeks to apply a new position retroactively, it is not enough for the agency to demonstrate that its new interpretation is within the meaning of the law. *Id.* at 387. Rather, the IBLA held that the burden of clearly setting forth and identifying its change in sufficient detail to show that the departure from the prior position was not arbitrary and capricious. *Id.* at 387-88. Furthermore, the MMS must satisfy the balancing test set out in *Retail, Wholesale & Dep't Store Union v. NLRB*, 466 F.2d 380, 390 (D.C. Cir. 1972), which requires the court to determine:

> (1) whether the case is one of first impression; (2) whether the new rule is an abrupt departure from well-established practice or merely an attempt to fill an unsettled area of law; (3) the extent to which the party against whom the new rule is applied relied on the old rule; (4) the burden which a retroactive order imposes on that party; and (5) the statutory interest in applying a new rule retroactively.

This Court agrees with the bankruptcy court that the MMS did not even attempt to satisfy its burden of proving that its interpretation of "gross proceeds" should be made retroactive under the criteria established in *Sun Exploration*. Therefore, the bankruptcy court correctly determined that the interpretation upon which MMS' royalty claim is based cannot be applied retroactively to this action.

E. *IPAA V. BABBITT* IS NOT BINDING ON THIS COURT

In *Independent Petroleum Association of America v. Babbitt*, __ F.3d__ (D.C. 1995), which affirmed the Assistant Secretary's decision in *Samedan, supra*, the district court considered whether the government was entitled to royalties on gas settlement contract entered into between Samedan and Southern. The district court determined that the MMS' order to pay royalties is in accordance with the law and is a permissible construction of the agency's rules and regulations and affirmed the Assistant Secretary's decision requiring Samedan to pay $20,000.00 in royalties to the United States.

Although the Court has reviewed and considered the decision of the court in *IPAA v. Babbitt*, that opinion is not binding on this Court. Moreover, the IPAA recently filed a notice appealing the decision in that case to the United States Court of Appeals for the District of Columbia Circuit.

F. THE BANKRUPTCY COURT ERRED IN HOLDING THAT THE ROYALTY CLAIM IS BASED ON AN INTERPRETATION OF THE GROSS PROCEEDS RULE THAT WAS ADOPTED IN VIOLATION OF THE APA'S NOTICE AND COMMENT REQUIREMENT

Although the bankruptcy court correctly determined that the MMS' royalty claim exceeds the MMS' statutory, regulatory, and contractual authority, is arbitrary and capricious, and is unlawfully retroactive, the bankruptcy court erred when it held that the MMS' royalty claim was based on an interpretation of the gross proceeds rule that was adopted

in violation of the APA. The bankruptcy court held that the Assistant Secretary of the DOI, in issuing *Shell Offshore*, failed to comply with the rulemaking requirements of the APA. Generally, the APA requires notice and an opportunity for comment before a rule can be implemented. 5 U.S.C. § 553(b). However, in *Shalala v. Guernsey Memorial Hospital*, 115 S. Ct. 1232 (1995), the Supreme Court recently held that notice and comment are not required under the APA when an agency issues an interpretative rule. An "interpretative rule" is defined as a rule "issued by an agency to advise the public of the agency's construction of the statutes and rules which it administers." *Id.* at 1238. Because the decision in *Shell Offshore* advises the public of the DOI's construction of OCSLA and the gross proceeds rule as applied to contract settlement payments, it is an interpretative rule and the APA's notice and comment requirements are not required. Consequently, the bankruptcy court erred in concluding that the Assistant Secretary's decision in *Shell Offshore* failed to comply with the APA's notice and comment requirements. This error, however, does not affect the other grounds on which the bankruptcy court granted Century's motion for summary judgment.

VI. THE BANKRUPTCY COURT DID NOT ERR IN DENYING THE UNITED STATES' CROSS-MOTION FOR SUMMARY JUDGMENT

For the foregoing reasons, the bankruptcy court did not err in granting Century's motion for summary judgment and denying the United States' cross-motion for summary judgment.

VII. CONCLUSION

For the foregoing reasons, the bankruptcy court correctly granted Century's motion for summary judgment and denied the United States' cross-motion for summary judgment.

Accordingly, the Court hereby ORDERS:

(1) the motion for oral argument [docket entry 8] is DENIED;

(2) the bankruptcy count's order of February 13, 1995 is AFFIRMED; and

(3) this matter is STRICKEN from the active docket.

This 4th day of August 1995.

/s/ Karl S. Forester
KARL S. FORESTER,
JUDGE

NOTICE IS HEREBY GIVEN OF THE
ENTRY OF THIS ORDER OF JUDGEMENT
ON 8/4/95
LESLIE G. WHITMER, CLERK
BY: /s/ Larry G. Brown D.C.

IN THE UNITED STATES BANKRUPTCY COURT
FOR THE EASTERN DISTRICT OF KENTUCKY
LEXINGTON DIVISION

CASE NO. 93-51340
CHAPTER 11

EASTERN DISTRICT OF KENTUCKY
FILED
FEB 13 1995
AT LEXINGTON
BETTY L. JENNETTE, CLERK
U.S. BANKRUPTCY COURT

IN RE: CENTURY OFFSHORE MANAGEMENT CORPORATION,

Debtor.

FINDING OF FACT AND CONCLUSIONS OF LAW

Pursuant to Rule 7056, Federal Rules of Bankruptcy Procedure which incorporates Rule 56, Federal Rules of Civil Procedure, the Court enters these findings of fact and conclusions of law based on the pleadings and evidence submitted by the parties. Oral argument was heard by the Court on January 20, 1995.

PROCEDURAL BACKGROUND

1. On August 23, 1993, Century Offshore Management Corporation ("Debtor" or "Century") filed a petition for relief under Chapter 11 of the United States Bankruptcy Code

2. On February 11, 1994, the United States of America filed two proofs of claim on behalf of the Minerals Management Service ("MMS") of the United States Department of Interior ("DOI"). Only one claim is presently in dispute. The disputed claim is a claim for additional oil and gas royalties in the amount of $1,855,004 00 ("Royalty

Claim"). In connection with the Royalty Claim, the MMS alleges that, as a result of the Debtor's receipt of a lump sum payment from Enron Gas Marketing ("Enron"), Century owes a royalty payment to the MMS, and, by failing to pay such alleged royalty obligation, has breached its lease agreement with the MMS.

3. On May 13, 1994, the Debtor filed its objection to the MMS Royalty Claim.

4. On or about May 19, 1994, the MMS filed a motion to withdraw the reference with respect to the MMS Royalty Claim and the Debtor's objection to the claim.

5. On October 25, 1994, the United States District Court denied the MMS' motion.

6. On December 16, 1994, Century filed a motion for summary judgment determining that, based on undisputed facts and as a matter of law, the MMS is not entitled to royalties on a contract settlement payment that Enron made to Century in order to terminate Enron's obligations under certain gas purchase contracts with Century.

7. On January 16, 1995, the MMS filed an opposition to Century's motion as well as a cross-motion for summary judgment determining that royalties of $1,004,422.70 are currently due on the contract settlement payment that Century received from Enron. In its motion, the government also claims that additional royalty payments of unspecified amounts may be due to the government at unspecified times during the period ending September 30, 1995.

8. On January 20, 1995, the Court held a hearing on the motion for summary judgment filed by Century.

FINDINGS OF FACT

1. Debtor Century is a corporation organized under the laws of the State of Kentucky.

2. Century produces natural gas from various leases of oil and gas underlying submerged federal lands on the Outer Continental Shelf offshore the State of Louisiana.

3. During April 1987, Century acquired a working interest in a lease of oil and gas underlying federal submerged lands on the Outer Continental Shelf commonly known as the West Cameron Block 368 Lease ("WC 368 Lease").

4. During June 1989, Century acquired a working interest in a lease of oil and gas underlying federal submerged lands on the Outer Continental Shelf commonly known as the South Timbalier Block 107 Lease ("ST 107 Lease").

5. During April 1990, Century acquired a working interest in a lease of oil and gas underlying federal submerged lands on the Outer Continental Shelf commonly known as the Breton Sound Block 53 Lease ("BS 53 lease").

6. On December 20, 1989, Century and Enron entered into a contract under which Enron agreed to purchase natural gas that Century produced from the ST 107 Lease ("ST 107 Base Contract").

7. On March 23, 1990, Century and Enron entered into a contract under which Enron agreed to purchase natural gas that Century produced from the WC 368 and BS 53 Leases ("WC 368 Base Contract").

8. In addition to the base contracts described above, Century and Enron entered into several other gas purchase contracts covering these fields. Under those contracts, Enron had the right, under certain circumstances, to purchase additional quantities of gas from these fields at agreed prices.

9. During November 1991, Enron informed Century that Enron wished to purchase the natural gas contracts between Century and Enron covering the ST 107, WC 368, and BS 53 Leases. During negotiations on that matter, Enron presented Century with a calculation of the present value of the payments that Enron would be required to make under the contracts during their remaining terms if Enron failed to purchase the minimum quantities of gas required by those agreements and instead paid Century the non-recoupable payments required for failure to make those purchases. Century presented Enron with a similar calculation.

10. On the basis of negotiations concerning those calculations, on February 12, 1992, the parties entered into a "Termination of Gas Purchase Agreements." Under that agreement, Enron made a lump sum, non-recoupable payment to Century of $12, 250, 000. Century has not paid royalties to the federal government on any portion of that lump sum payment.

CONCLUSIONS OF LAW

1. The objection to claim and the summary judgment action filed by Century are core proceedings pursuant to 28 U.S.C. § 157(b)(2)(8) and are also governed by Rule 9014, Federal Rules of Bankruptcy Procedure. The Court has jurisdiction pursuant to 28 U.S.C. § 1334(b).

2. The ST 107, WC 368, and BS 53 Leases were issued under Section 8 of the Outer Continental Shelf Lands Act of 1953 ("OCSLA"), 43 U.S.C. §1337. Under Section 8(a) of OCSLA, the federal government is entitled to a royalty based on a percentage of the "amount or value of the production saved, removed, or sold" from the leased premises. 43 U.S.C. §1337(a). Identical language is contained in the royalty clause of the ST 107, WC 368, and BS 53 Leases.

3. Under the "gross proceeds" rule, the "value of production" for royalty purposes cannot be less than the gross proceeds "accruing to the lessee for lease production . . ." 30 C.F.R. § 206.152(h) (1993).

4. In *Diamond Shamrock Exploration Corp. v. Hodel,* 853 F.2d 1159 (5th Cir. 1988), the United States Court of Appeals for the Fifth Circuit construed and applied the federal law applicable to oil and gas leases located on the Outer Continental Shelf. In that opinion the appellate court considered the proper interpretation of the term "value of production" in Section 8(a) of OCSLA, which, as noted above, is also used in the "gross proceeds" rule as well as the federal offshore leases in this case.

5. As construed in *Diamond Shamrock*, for royalty purposes, "production" means the actual physical severance of the minerals from the formation:

> In the interests of consistency, logic and economics, this court adopts as the legal definition of the word "production," as used in the context of calculating royalty payments, the actual physical severance of minerals from the formation. For purposes of royalty calculation and payment, production does not occur until the minerals are physically severed from the earth.

Id. At 1168 (footnote omitted). The Fifth Circuit noted that this definition of "production" was "consistent with, and, indeed, identical to," definitions adopted by numerous other courts including the United States Supreme Court; the United States Court of Appeals for the Ninth Circuit; the United States Court of Appeals for the Tenth Circuit; and courts in the States of Louisiana, Montana, Texas, and Wyoming. *Id.* at 1168 n. 39. *See also Associated Gas Distributors v. FERC*, 893 F.2d 349 at 359 (D.C. Cir. 1989) (unrecoupable buyout and buydown settlements are not payments for the purchase of gas, they are payments for the failure to purchase gas).

6. In *Diamond Shamrock* the Fifth Circuit interpreted the "plain meanings of the words in the lease, and in the relevant statutes and regulations". *Id* at 1165. The unequivocal holding of the Court was that

> [i]t is obvious from a complete reading of all the relevant statutes, regulations and lease provisions, that royalties are not due on "value" or even "market value" in the abstract, but only on the value of *production saved, removed or sold* from the leased property. Likewise, the agency's regulations do not refer to "gross proceeds" in the abstract, but only to gross proceeds that accrue to the lessee from the disposition or sale of *produced substances*, that is, gas actually removed and delivered to the pipeline. Consequently, royalties are not owed

> unless and until actual production, the severance of minerals from the formation, occurs. (emphasis in original)

Id. Twice in its *Diamond Shamrock* opinion the Court makes it clear that the plain meaning of all relevant language is that royalties are due on these types of federal leases only when there has been production, meaning the severance of the minerals from the producing underground formation.

7. The unequivocal ruling of the Fifth Circuit Court of Appeals is applicable to the present undisputed fact situation. Under the ST 107 Base Contract, Enron agreed to purchase certain minimum quantities of gas from the ST 107 Lease. ST 107 Base Contract at §3.1. This minimum purchase quantity was defined in Section 1.1 of the contract as follows:

> "*Minimum Purchase Quantity*", for any month during the term of this Agreement, shall mean the minimum quantity of Gas, expressed in MMBtu per day, that Buyer is obligated to purchase and receive, or pay for if available and not taken, during such month, which quantity shall be ninety percent (90%) of the MDQ [Maximum Daily Quantity] times the number of days in such month.

Under Section 3.4 of the contract, Enron was required to make nonrecoupable payments to Century in each month in which Enron failed to purchase that minimum quantity. Under Section 11.1, Enron's monthly obligation to take minimal quantities of gas or make a nonrecoupable payment to Century for gas not taken remained in effect through March 1996. The parties subsequently extended this monthly take-or-pay obligation through October 1996.

8. Enron had identical take-or-pay obligations to Century under the West Cameron 368 Base Contract, which, as noted above, also covered Century's production from the BS 53 Lease. Under Section 3.1 of that contract, Enron was required to purchase each month certain minimum quantities of gas from the WC 368 and BS 53 Leases. Under Section 3.4 of that contract, Enron agreed to make a non-recoupable

payment to Century in each month in which Enron failed to purchase that minimal quantity. Under Section 11.1, Enron's monthly obligation to either purchase the minimum quantity of gas or make a non-recoupable payment to Century extended through September 30, 1995.

9. The $12.25 million payment that Enron made to Century was to extinguish Enron's future obligations under the ST 107 Base Contract and the WC 368 Base Contract. The calculation that Enron presented to Century when Enron offered to buy out these contracts was based on the non-recoupable payments that Enron would have made to Century during the period February 1992 through October 1996 in the event Enron did not purchase the minimum monthly quantities of gas required by those contracts. The calculation that Century presented to Enron was also based on those non-recoupable payments

10. Enron's payment to Century was not for hydrocarbons severed by production, but was to relieve Enron of its future obligations under the ST 107 Base Contract and WC 368 Base Contract to make non-recoupable payments to Century when Enron failed to purchase the minimum quantities of gas required by those contracts. The payment was the price that Century negotiated to terminate the gas purchase contracts. It was not a price paid for either present or future deliveries of severed hydrocarbons to Enron. Thus, Enron's payment is not royalty bearing under Section 8(a) of OCSLA as that section was interpreted in *Diamond Shamrock.*

11. As a further basis for this Court's ruling, the Court finds and concludes that Debtor's motion should be granted on the basis of the government's own interpretation of its "gross proceeds" rule. Rather than appeal the decision in *Diamond Shamrock,* the MMS instead formally amended the agency's "gross proceeds" regulation to conform it to the decision in the *Diamond Shamrock* case. 53 Fed Reg. 45,082 (November, 8 1988). As noted above, that decision limits "gross proceeds" to the market value of the severed

hydrocarbons at the time they are severed. Having adopted that definition, the MMS is not free in this case to expand its meaning to include payments that do not represent proceeds from severed hydrocarbons at the time those substances are severed but instead represent payments made to relieve Enron of its future obligations under natural gas purchase contracts.

12. Further reason exists to sustain the Debtor's motion based on the royalty provisions of the ST 107, WC 368, and BS 53 Leases. As noted above, those royalty provisions track the language of Section 8(a) of OCSLA. Thus, the leases limit the MMS' royalty to the value of the severed production, i.e., the produced substances, and do not permit the government to demand a royalty on non-recoupable payments made by the purchaser when the purchaser fails to purchase the required minimum quantities in accordance with its contracts. The government cannot unilaterally amend those contracts to retroactively substitute a royalty clause that is more favorable than the clause the government bargained for.

13. The Court rejects the various arguments offered by the MMS for avoiding the unambiguous holding of *Diamond Shamrock*. The MMS' argument that Enron's payment was a prepayment for gas is the exact same argument that was adopted by Judge Sear and which is discussed in *the Diamond Shamrock* case. *See* 853 F.2d at 1163. That argument, however, was rejected by the Fifth Circuit as inconsistent with Congress' intent in enacting Section 8 of OCSLA; inconsistent with the unambiguous language of the DOI's "gross proceeds" rule; and violative of the royalty provisions of the standard offshore lease form that was prepared by the government. The government's prepayment argument is rejected here for the same reasons.[1]

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[1] The government is equally incorrect in claiming that this Court should defer to the government's interpretation of the "gross proceeds" rule as set forth in *Shell Offshore Inc.*, Docket No. MMS-91-0171-OCS (September 2, 1994). There is no need or obligation to defer to an agency when a court has already issued a definitive interpretation of the statute, the implementing regulations, and the relevant contractual provisions.

14. Moreover, the Court finds that the interpretation of "gross proceeds" that is purportedly set forth in *Shell Offshore* is inconsistent with DOI's prior interpretation of that regulation based on the *Diamond Shamrock* decision. For example, in a memorandum dated November 30, 1990, the Chief of MMS' Royalty Valuation and Standard Division considered whether DOI should grant a request by Chevron, U.S.A. for a refund of the royalties that Chevron paid on certain contract payments that terminated the purchaser's future obligations under natural gas contracts involving federal oil and gas leases. That memorandum notes first that in light of the decision in *Diamond Shamrock, supra,* the MMS has adopted as its position that *"any* payment" [2] received in advance of actual production is not royalty bearing unless that production was actually severed from the lease. The memorandum then concluded:

> In keeping with this position, contract "buy-out" payments received by a producer to free a purchaser from future obligations under a sales contract are *not* associated with production removed from the lease and, therefore, will *not* be subject to royalty.[3]

NationsBank of North Carolina v. Variable Annuity Life Insurance Co., 998 F.2d 1295 (5th Cir. 1993). This is particularly true here because, as discussed above, the government did not appeal the Court's interpretation but instead amended the agency's royalty regulations to adapt that interpretation.

[2] Exhibit L to Debtor's Motion for Summary Judgment at 1 (emphasis added).

[3] Exhibit L at 1. A Field Report attached to the Chief's memorandum reached a similar conclusion:

> *Any* contract buy-out payment received by a producer to free a purchaser from future obligations under a sales contract is *not* associated with production removed from the lease and, therefore, will not be subject to royalty.

Attachment to Exhibit L at p. 5 (emphasis added).

Based on that conclusion, the royalty valuation Chief recommended that Chevron's refund request be granted. Several days later, MMS sent Chevron a letter formally approving Chevron's request for refund of the royalties the company had previously paid on contract "buy-out" revenues.[4]

15. The decision that MMS issued to Chevron was not an aberration. Both before and after it issued that decision, MMS consistently determined, directly or indirectly, that contract settlement payments of this type were not royalty bearing. *See* "Revision of Gross Proceeds Definition in Oil and Gas Valuation Regulations, Final Rule," 53 Fed. Reg. 45,082 (November 8, 1988); "Revision of Coal Product Valuation Regulations and Related Topics, Final Rule," 54 Fed. Reg. 1492, 1513 (January 13, 1989); Letter from Milton K. Dial, Chief, Royalty Valuation and Standards Division of MMS to Jerry United, ARCO Coal Co. (July 7, 1989); *Wolverine Exploration Co.*, Docket Nos. MMS-88-0052-IND and MMS-88-0096-IND (May 2, 1990); Letter from Donald T. Sant, Deputy Associate Director for Valuation and Audit of MMS to Chief, Royalty Compliance Division and Chief, RVSD (October 8, 1991).[5] Thus, at least prior to the issuance of the MMS' "Dear Payor" letter dated May 3, 1993, MMS consistently held that a contract settlement payment was *not* royalty bearing under the royalty provisions of Section 8 of the OCSLA.

16. The Court also concludes that the government's royalty claim may not lawfully be based on the May 3, 1993 "Dear Payor" letter that MMS mailed to various companies that report and pay royalties on federal oil and gas leases. [6]

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[4] Exhibit M to Debtor's Motion for Summary Judgment.

[5] Copies of these documents were attached as Exhibits O through S of Debtor's Motion for Summary Judgment. *See* also Exhibits T through W to that motion.

[6] In that letter, Mr. James W. Shaw, the Associate Director for Royalty Management, expressed his view that in some circumstances, some portion of a contract "buy-out" might be royalty bearing if the

Informal statements of agency policy never have the force and effect of law. *E.g., Mesa Operating Limited Partnership*, 125 IBLA 28 (1992), *aff'd in relevant part on reconsideration*, 128 IBLA 174 (1994). For this reason alone, the government may not properly rely on MMS' May 3, 1993 "Dear Payor" letter.

17. In the alternative, the May 3, 1993 "Dear Payor" letter exceeds the DOI's statutory, regulatory, and contractual authority under OCSLA. Under Mr. Shaw's "analysis", a "buy-out" payment to extinguish future obligations under a natural gas purchase contract can, at least in some circumstances, constitute a prepayment for gas and, as a result, become "gross proceeds accruing to the lessee for lease production" within the meaning of 30 C.F.R. § 206.152(h) (1993). As noted above, however, this argument has already been rejected by *Diamond Shamrock* and the holding of that case has been adopted by MMS.

18. Even assuming that the royalty provisions of OCSLA somehow permitted the government to claim royalties on contract payments of the type made by Enron, this Court would nonetheless be required to reject the Royalty Claim made by the government. As Debtor correctly notes, the interpretation of "gross proceeds" on which MMS relies was issued without compliance with the notice and comment requirement of the Administrative Procedure Act ("APA"), 5 U.S.C. § 553. *See, e.g., Phillips Petroleum Co. v. Johnson*, 22 F.3d 616 (5th Cir. 1994). In that case, the Fifth Circuit recently struck down an MMS attempt to base royalty values

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"buy-out" constituted a payment for natural gas that was purchased under a follow on or a successor contract. The "Dear Payor" letter goes on to describe complicated new criteria -- nowhere found in MMS' royalty regulations -- for determining the portion of a "buy-out" payment, if any, that is royalty bearing under a successor contract, and the months during the term of the successor contract in which that portion becomes royalty bearing. A copy of that letter is attached as Exhibit N to Debtor's Motion for Summary Judgment.

for certain natural gas liquids on the values in an internal "Procedure Paper" because those values were not adopted in accordance with the rule making requirements of the APA. In short, the new royalty values informally set forth *Shell Offshore* are ineffective and unenforceable.

19. In any event, MMS' royalty claim is based on an interpretation of "gross proceeds" that is arbitrary and capricious. First, those values unfairly provide a windfall benefit to the government. As the Fifth Circuit recognized in *Diamond Shamrock*, the purpose of minimum take requirements is to apportion the risks of natural gas production and sale between the buyer and seller. 853 F.2d at 1167. Payments related to those minimum take requirements, like those required by Section 3.4 of the ST 107 and WC 368 Base Contracts, are intended to compensate the producer, not the owner of the minerals, for the risks associated with development and production:

> In fact, this is the precise reason for entering into a lease agreement. The government leases oil producing lands in order to, among other things, reap the benefits, through royalty payments, without having to shoulder the associated risks of exploration, production and development.

853 F.2d at 1167.[7] Under these circumstances, it would be completely irrational to let the government share in any revenues that the producer realized by taking those market risks while simultaneously protecting the government from any and all losses suffered by the producer from taking those same risks.

20. Permitting the government to receive royalties on contract settlement payments in the manner urged by MMS in

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[7] The government shares none of the risks or expenses of exploration, production, or development. However, the government does provide itself with a steady supply of revenue through provisions for a minimum royalty in the event there is little or no royalty bearing production. ST 107 Lease at paragraph 5; WC 368 Lease at paragraph 5; BS Lease at paragraph 5.

this case would lead to the same kinds of absurd results that troubled the Fifth Circuit in *Diamond Shamrock*. In that case, the Court found that MMS' position could, in some instance, require the lessee to make two royalty payments on one sale of gas. *Id.* at 1166. The Court also found that DOI's position could in some cases unfairly deprive producers of refunds of admitted royalty overpayments. *Id.* The Court further found that in some instances, the government's position completely distorted the concept of "fair market value" on which the government's royalty valuation rules were based. *Id.* at 1166-67.

21. The government claim in this case is based on an interpretation of "gross proceeds" that produces these same unsound and untenable results. Indeed, the government's position necessitates two royalty payments on one sale of gas in almost every case where the producer sells gas after the original contract is terminated. In that circumstance, the producer must pay one royalty based on the proceeds received for the sale of gas under the successor contract. Under the government's logic, the producer must then pay a second royalty on that same sale based on the portion of the settlement payment which MMS allocates to that sale. Thus, like the royalty values struck down in *Diamond Shamrock*, the government's claim unreasonably necessitates two royalty payments on one sale of gas.

22. In addition, MMS' position, if adopted by this Court, would unfairly deprive producers of refunds of admitted royalty overpayment and, consequently, result in undeserved royalty windfalls to the government. The government claims to have broad discretion to reallocate a settlement payment among the various issues settled (i.e., buy-down", "buy-out", pricing disputes, take-or-pay disputes, etc.) and/or among the various leases covered by the settlement.[8] By contrast, a producer has only two years in

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[8] See MMS "Dear Payor" Letter dated May 3, 1993. Moreover, there may be no time limit on such reallocations because the Fifth Circuit Court of Appeals recently held that the six year statute of limitation in 28 U.S.C.

which to seek a refund of a royalty overpayment made on a federal offshore lease. *See* 43 U.S.C. § 1339. As a result, there will be many instances in which producers will lose the right to a refund of an admitted royalty overpayment merely because of the government's lack of diligence in pursuing claims of this type.[9]

23. Finally, the government's proposed interpretation of "gross proceeds" distorts the concept of "fair market value" on which the government's royalty regulations are based. Under its position in this case, the government pretends that a payment made to terminate future obligations under an exclusive sales contract is part of the "market value" of natural gas that will be produced and sold at a later time to the same or a different purchaser. But if the purchaser does not take gas under the original exclusive contract, there is no market for that gas. With no production, there is nothing to value by market or otherwise. Claiming that any portion of the settlement payment is part of the "fair market value" of gas sold at a later time under a different contract cannot logically be supported.[10] Even if they were otherwise lawful, the governments "rules" for assessing royalties on contract "buy-outs" are arbitrary and capricious, and do not constitute a lawful basis for the royalty demand in this case.

24. The Court further concludes that, even if otherwise lawful, the government's interpretation is unlawfully retroactive under the criteria established by the *Department of Interior in Sun Exploration and Production Co.*, 112 IBLA 373 (1990). In that case, the Interior Board of Land and Appeals ("IBLA" or "Board") sharply limited the

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§ 2415 does not apply to royalty claims by MMS. *See Phillips Petroleum Co. v. Johnson*, No. 93-1377, (Slip Opinion Dated September 7, 1994).

[9] Because it gets to retain the resulting royalty windfall, the government actually has an incentive to delay challenges of this type until after the two year time limit on refunds has expired.

[10] Under the government's analysis, this sale could occur many years after the settlement payment was made and could involve a purchaser that is completely unrelated to the purchaser making the settlement payment.

circumstances in which MMS may apply a new interpretation of a regulation retroactively. Specifically, the Board rejected an MMS attempt to give retroactive effect to a new interpretation of the term "production" for purposes of applying the sliding-scale royalty provisions of a lease. As the Board stated in that case, when MMS departs from a prior administrative position and seeks to apply a new position retroactively, it is not enough for the agency to demonstrate that its new interpretation is within the meaning of the law. *Id.* at 387. Rather, the MMS has the burden of clearly setting forth and identifying its change in sufficient detail to show that the departures from the prior position was not arbitrary and capricious. *Id.* at 387-88.

25. In addition, to give its new interpretation retroactive effect, the MMS must satisfy the balancing test set out in *Retail, Wholesale & Dep't Store Union v. NLRB*, 466 F.2d 380, 390 (D.C. Cir. 1972); *see also Runnells v. Andrus*, 484 F. Supp. 1234 (D. Utah 1980).[11]

26. In its claim, MMS has not attempted to satisfy its burden of proving that its new interpretation of "production" should be made retroactive under the criteria established by the Department of Interior itself in *Sun Exploration & Production, supra*. Nor could MMS make such a showing in view of (1) the Fifth Circuit holding in *Diamond Shamrock* concerning the royalty provisions of OCSLA; and (2) the MMS' decision to formally amend its royalty regulations in order to adopt the Court's holding in that case.

27. For the foregoing reasons, the Court concludes that the Department of Interior lacks statutory, regulatory, and

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[11] This balancing test requires the court to determine: (1) whether the case is one of first impression; (2) whether the new rule is an abrupt departure from well-established practice or merely an attempt to fill an unsettled area of law; (3) the extent to which the party against whom the new rule is applied relied on the old rule; (4) the burden which a retroactive order imposes on that party; and (5) the statutory interest in applying a new rule retroactively. *Retail, Wholesale & Dep't Store Union v. NLRB*, 466 F.2d at 390.

contractual authority to demand a royalty on the contract settlement payment that Enron made to Century to terminate Enron's future obligations under the ST 107 Base Contract and WC 368 Base Contract. Accordingly, the Court finds that Debtor's motion for summary judgment should be sustained. This renders the government's cross-motion for summary judgment moot.

28. In light of the foregoing, there is no genuine issue as to any material fact, and Century is entitled to a judgment as a matter of law that royalties are not due on the contract settlement payment that Century received from Enron. For the same reasons, the government's cross-motion for summary judgment is denied. Judgment shall be entered accordingly.

Dated: February 13, 1995

/s/ Joe Lee
Joe Lee
United States Bankruptcy Judge